Royal London Sustainable Managed Income Trust

Quarterly Report 31 December 2021

Top ten holdings

	Trust (%)
Aviva 6.875% 2058	1.2
HSBC Bank 5.375% 2030	1.0
Quadrant Housing 7.93% 2033	0.9
Penarian Housing Finance Plc 3.212% 2052	0.9
Sunderland 6.38% 2042	0.9
Harbour Funding 5.28% 2044	0.9
Scottish Widows Plc 7% 2043	0.8
Western Power Distribution 5.75% 2032	0.8
Scottish Power 6.5% Step 2041	0.8
Derby Healthcare 5.564% 2041	0.8
Total	**8.9**

Trust data

	Trust	Benchmark[1]
No. of stocks	318	1,158
Fund size	£280.7m	-
Duration[2]	7.6 years	7.9 years
Gross redemption yield[3]	2.28%	1.83%
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

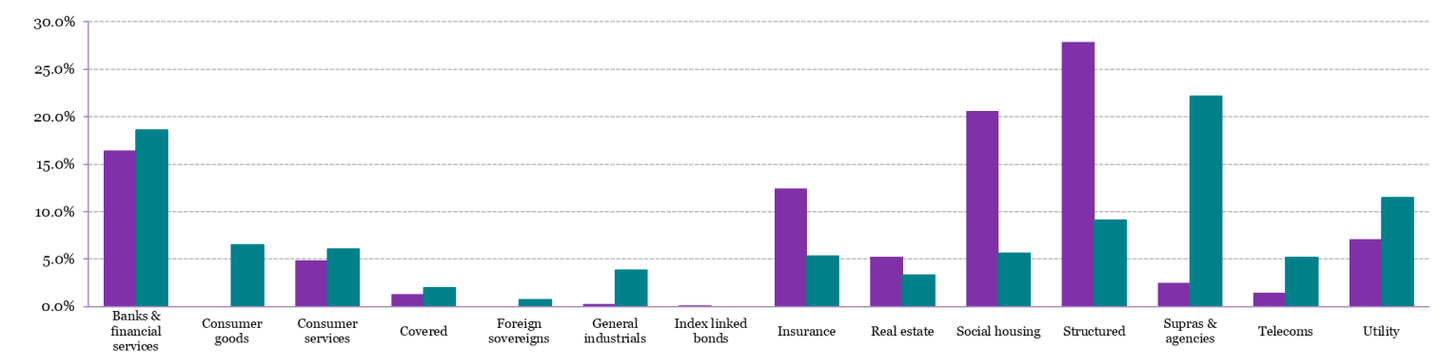
	Trust (C Acc)(%)	Benchmark[1] (%)	Relative (%)
Q4 2021	**0.74**	**0.34**	**0.40**
Year-to-date	-0.64	-3.09	2.45
Rolling 12 months	-0.64	-3.09	2.45
3 years p.a.	5.87	4.51	1.37
5 years p.a.	4.63	3.23	1.39
Since inception p.a. 07.12.2012	5.14	4.40	0.74

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

Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Index linked bonds	Insurance	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
Trust	16.4%	0.0%	4.9%	1.3%	0.0%	0.2%	0.1%	12.4%	5.2%	20.6%	27.9%	2.5%	1.4%	7.1%
Benchmark	18.6%	6.5%	6.1%	2.0%	0.8%	3.8%	0.0%	5.3%	3.3%	5.7%	9.1%	22.1%	5.2%	11.5%

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

Executive summary

- Our equity portfolios, whether in equity-only or mixed asset funds, performed strongly this quarter. As a result of this strong quarterly performance, the funds also delivered strong relative returns for the year as a whole.
- UK and global equities delivered strong returns over the fourth quarter. Sustainable Leaders benefitted from its exposure to global equities as these outperformed UK equities in sterling terms. Our conviction that equities will outperform credit means that our mixed-asset funds are more fully weighted in equities than some of their peer group. Otherwise, our equity portfolios benefitted from the ongoing strength of corporate earnings and the resilience of global stock markets against concerns about Covid-19 variants and inflation. However, the main reason for our outperformance was stock picking as the high-quality companies that we favour continued to perform strongly.
- While sterling credit markets were more pedestrian than equities over the quarter, **our credit exposure (in the funds where we hold sterling credit)** funds still delivered positive absolute returns and performed well on a relative basis. This primarily reflected the overweight allocations to secured sectors and, to a lesser extent, the low weighting in supranational bonds. Unusually, however, sector allocation was not a key driver of returns, with performance mostly driven by stock selection within sectors.
- The volatility that blew up at points in 2021 has already been evident this year as the Federal Reserve (Fed) has indicated that it is prepared to increase interest rates earlier and faster than previously signalled. With the withdrawal of quantitative easing (QE) programmes and rising rates, markets will undoubtedly remain volatile. Despite the short-term spike, we are not yet convinced about the arguments for inflation returning in the long term. Our view is that it is more likely that the pandemic will ultimately prove a long-lasting deflationary force as technology reduces our dependence on finite physical resources. Also, there are plenty of drags on growth that will mitigate inflationary pressures, including higher taxes, the slowdown in growth in China and the drag of any further Covid-19 variants. While central banks are raising interest rates sooner than anticipated a few months ago, we believe that we will remain are in a low interest rate environment for much longer than current market sentiment suggests.
- While the macro environment is very uncertain, the micro factors have never been clearer. The pandemic and its aftermath have accelerated the sustainability agenda across governments, businesses and consumers. This will be positive for the types of company that we seek to invest in. Overall, we remain positive on equities as the global economy continues to recover from the impact of Covid-19 – that, after all, is why interest rates are being raised. We therefore maintain our pro equity stance in the mixed asset strategies.

Market overview

- The themes that influenced the market throughout 2021 continued in the fourth quarter: periods of volatility – arising from new strains of Covid-19, renewed travel restrictions and lockdown measures, as well as concern about inflation and the implications for QE and interest rates – may have filled the headlines, yet corporate earnings continued to surprise on the upside and push equity markets to new highs.
- The issues that had concerned investors in the last few weeks of the third quarter continued to play out, albeit without significant effects on global financial markets. The travails of the giant Evergrande property company and the deflation of the Chinese real estate bubble continued. Meanwhile, bottlenecks in supply chains caused by Covid disruption (and, in the UK, possibly exacerbated by Brexit) continued to result in shortages and price spikes. However, fears of inflation seemed to ease with a change in rhetoric and some action from central bankers. The Bank of England surprised investors in December by raising the UK base rate for the first time in three years – from 0.1% to 0.25% – as the Omicron variant hit the UK, having held steady in November; while the Fed started to taper its QE programme and guide investors to earlier and faster rate rises in 2022. Investors were relatively sanguine about these policy changes as they had been trailed from September and, to an extent, taking moderate action on inflation was seen as less of a risk than no action.
- Whereas the third quarter started with the spread of the Delta variant of Covid-19, the fourth quarter began with some confidence about vaccine programmes and the rollout of booster jabs. There was initial concern about the rapid spread of the Omicron variant as the holiday season loomed; however, while there are ongoing fears about the ability of healthcare systems to cope with the huge numbers of new cases and the impact of staff shortages on key services, investors took comfort from early data from South Africa that suggested that, while highly contagious, this variant is less deadly, and vaccines remain effective in mitigating its effects. While not being complacent, we have maintained throughout the last 18 months that society and investors would be increasingly effective in dealing with new strains of Covid, and so far Omicron fits this thesis.
- The quarter was somewhat mixed for global equities, with increased volatility in November leading to more pedestrian returns (the FTSE All-Share actually returned -2.2% in November, while the MSCI ACWI still delivered a positive return of 1.1% to sterling investors): however, the strong positive returns in October and December more than compensated. As a result, for the fourth quarter the FTSE-All Share, MSCI World

and MSCI All Countries World Index (ACWI – which also includes 26 emerging markets) returned +4.2%, +7.3% and +6.2% to sterling investors, respectively. For the year as a whole, these indices returned +18.3%, 23.4% and 20.0%, respectively.

- Regional returns were more dispersed than for many recent quarters. The deflation of the Chinese property bubble impacted economic growth as did the impact of the country's 'zero Covid' lockdowns strategy, affecting the returns from emerging markets and Asia-Pacific (ex-Japan). According to MSCI regional data, the US was the strongest regional market, returning +9.5% to sterling investors, while Europe (ex-UK) and the UK returned +5.45% and +5.15%, respectively. Meanwhile, the returns in sterling terms from emerging markets and Asia-Pacific (ex-Japan) were -1.9% and -2.1%, respectively. Japan was the weakest regional market, returning -4.3%, having been the strongest in the third quarter when investors welcomed the resignation of Prime Minister Suga and the potential for further economic reforms.
- Technology led sector returns (+12.7%), followed by utilities (+10.8%) and real estate (10.4%). The weakest sector returns were from energy (+4.2%) and financials (+3.4%), with communication services delivering the only negative returns (-2.2%). The MSCI World Growth Index returned +7.6% versus +6.8% for the MSCI World Value Index.
- In UK bond markets, the benchmark 10-year gilt yield fell from 1.02% to 0.97% over the quarter, leading gilts to return 2.42% on an all-maturities basis (FTSE Actuaries). The apparent stability of the gilts market is misleading, however: having risen to 1.20% in late October, the 10-year gilt yield rallied to just 0.70% on 13 December (before the Bank of England raised the UK base rate). Credit market returns were more pedestrian with sterling investment grade credit returning 0.34%, 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 from 0.87% to 0.98%. For the year as a whole, the rise in gilt yields (from 0.20% to 0.97% for the 10-year gilt) led gilts to return -5.16% – by way of context, 2021 was the worst year for global sovereign bonds since 1999. Sterling investment grade credit returned -3.09%, with the credit spread tightening by one basis point to 0.98%.
- Most summaries of the fourth quarter will refer to 'volatility', but what does it mean in practice? If we look at October, returns for the month were not abnormal. However, over the period, the one-year sterling money market rate was up from 0.38% to 0.82% while the yield of the five-year gilt rose from 0.54% to 0.74% (from -0.06% at the start of the year). Conversely, compared to the rising yields seen in money markets and short gilts, the yield of the 50-year gilt *fell* from 1.16% to 0.87% over the quarter, corresponding to a rise in price of over 11%, as the Budget delivered a £60bn reduction in gilt issuance
- Currency movements were muted in the fourth quarter. Sterling was one of the stronger global currencies, strengthening against the US dollar and euro to reach a two-year high as the Bank of England raised the UK base rate. The yen was a notable outlier, weakening 3.3% against the US dollar and falling to its lowest level since 2017.
- Commodities delivered mixed returns after rising strongly earlier in the year. Brent crude oil trod water, falling back to below $80 a barrel after weakness in November. However, it still enjoyed a remarkable year after being particularly weak in the initial aftermath of Covid-19 – for 2021 as a whole, the price of Brent crude increased by over 50%. Copper futures resumed their upward trend (+7.7%) after retrenching in the third quarter: prices rose nearly 27% for the full year. The gold spot price rose +2.2% to just below $1,800/oz.

Performance and activity

- Sterling credit sector returns were mixed for the fourth quarter. Real estate, healthcare, capital goods and utilities were particularly strong, and asset-backed securities again delivered strong returns compared to the broad market. Supranational bonds underperformed as did the financial sectors – senior and subordinated banks were weak, as were the subordinated insurance and covered bonds subsectors. Longer-dated bonds strongly outperformed shorter-dated issues – only bonds with maturities greater than 10 years delivered significant positive returns. Otherwise, A and AA rated bonds outperformed BBB rated bonds, but AAA rated bonds delivered negative returns.
- The outperformance of our sustainable credit portfolios in the fourth quarter was almost entirely attributable to stock selection; compared to recent quarters, sector selection made a negligible contribution. However, our preference for secured over unsecured bonds was a positive factor as real estate, social housing and asset-backed securities, where we are overweight, outperformed the broader market. Supranational bonds underperformed and the portfolios are significantly underweight in this sector. Against this, our overweight allocations to financials, particularly subordinated insurance, were detrimental to returns. Similarly, our overweight position in the BBB and below ratings bands was unhelpful as A and AA rated bonds outperformed.
- Our preference for secured debt over unsecured was a significant factor in our outperformance this quarter as the real estate, social housing and structured sectors all delivered above-market returns. One factor that helps existing asset-backed and secured debt is that they are not subject to regular issuance. This increases their scarcity value, as well as protecting lenders from otherwise damaging event risk. Even so, security is not a guarantee of performance and we must still focus on the underlying business model of the issuer. At the security level notable

contributions came from **Thames Water** (structured); **Poplar Housing**, **Southern Housing Group** and **Swan Housing** (social housing); and **British Land** and **Annington Finance** (real estate).

- One of the principal detractors from performance this quarter was the underperformance of the financials sectors, notably subordinated insurance. However, subordinated insurance and subordinated banks performed particularly strongly over the previous three quarters. In a diversified portfolio, it is normal for sectors and issuers to have periods of strength and weakness – as long-term lenders, rather than traders of bonds, we are committed to these sectors and feel that the risk/return balance, as well as the key role these borrowers play in society, continues to make them an attractive part of the portfolios.
- For sterling credit, new issuance tailed off in December due to increased volatility and seasonal factors, but all three months of the quarter were stronger than in 2020, and issuance for 2021 as a whole was robust and exceeded expectations. The favourable conditions that were in place in October meant that some deals that looked attractive initially were tightened during the book building phase to levels where we passed; however, as the market became more turbulent, spreads widened to more attractive levels. There was further issuance of labelled corporate bonds (such as green bonds) in the quarter. While we welcome the greater recognition of climate challenge and the higher focus on ESG, we do not believe that all 'labelled' bonds offer value or clarity of objective. We will continue to focus on integrating ESG risk and to add incremental value in overlooked areas of the market.
- Notable new issues in which we participated included a subordinated banks issue from French bank **BPCE**; and new issues from **Derwent** and **Lendlease Europe Finance** in the real estate sector. We also bought an asset backed securitisation from **Sage** (senior tranche backed by social housing lending); a 2036 issue from **Southern Housing Group,** adding to our exposure to social housing; and a 'tap' of an existing longer-dated issue of **Blend Funding**, switching out of another bond of this issuer for an increase in credit spread. Otherwise, we participated in a 50-year issue by **CPP Investments** (the Canada Pension Plan Investment Board) in the supranational sector, which was issued at 0.65% above government bonds, an attractive spread for AAA risk; and a long-dated issue from **Saltaire Finance**, funding affordable homes with the bonds fully backed by the Secretary of State for Communities and Local Government (also in the supranationals and agencies sector).
- 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). It is not just at times of economic distress that security is beneficial. When financing costs are low and private equity businesses are awash with cash, we can expect to see balance sheets being utilised to increase leverage. This will eventually lead to higher default risk in those more leveraged business models. Secured bonds also offer potential upside when issuers want to access assets that are encumbered by secured bonds.
- 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, infrastructure, financial resilience (such as insurance products to support individuals through shocks) and community funding (regulated banks and building societies focused on SME and retail lending).
- 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, financial resilience, 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.

Outlook

- The volatility that blew up at points in 2021 has already been evident this year as the minutes of the December FOMC meeting (published in early January) indicated that the Fed is prepared to increase rates earlier and faster than previously signalled. This has led to weakness in government bond markets and to a reappraisal of more highly-rated equity sectors, such as technology – with those stocks that are yet to make a profit particularly vulnerable. With the withdrawal of QE programmes and a return to rising rates – the Fed is expected to increase rates at least three times this year and the BoE is expected to make four increases (just two will take the UK base rate back to the highest level since early 2009) – markets will undoubtedly remain volatile. This may also have an impact on currencies, and emerging markets can struggle in such scenarios.
- Otherwise, the deflation of the Chinese property bubble that has been signalled by the collapse of the Evergrande property empire will impact economic growth in China. Growth will also be affected by the government's zero-tolerance approach to Covid-19, with cities with millions of inhabitants being locked down fully following a handful of positive cases. This will impact the growth in China (some economists forecast that growth in China will lag the US for the first time in years), but will also impact the wider Asia-Pacific region and indeed the world – the German

economy notably struggled in 2019 as the Chinese authorities sought to reign in the shadow banking sector. It should be noted that due to low corporate governance standards, we are underweight China in the **Global Sustainable Equity Fund**.

- Despite the short-term spike, we are not yet convinced about the arguments for inflation returning in the long term. Our view is that it is more likely that the pandemic will ultimately prove a long-lasting deflationary force as technology reduces our dependence on finite physical resources. Also, there are plenty of drags on growth that will mitigate inflationary pressures, including higher taxes, the slowdown in growth in China and the drag of any further Covid-19 variants. While central banks are raising interest rates sooner than anticipated a few months ago, we believe that we will remain are in a low interest rate environment for much longer than current market sentiment suggests. There may be some short-term pain, but inflation will ease by the second half of this year, benefitting strategies such as ours. By its very nature, sustainable investing is a long duration strategy – as it picks out companies and trends that will take many years to fully develop.
- As we currently say to clients in meetings, while the macro environment is very uncertain, the micro factors have never been clearer. This brings us back to sustainable investing and the core of fund management – identifying good companies, valuing them and (to a lesser extent) trying to time our investment or disinvestment to maximise the returns to clients. The pandemic and its aftermath have accelerated the sustainability agenda across governments, businesses and consumers. This will be positive for the types of company that we seek to invest in. Overall, we remain positive on equities as the global economy continues to recover from the impact of Covid-19 – that, after all, is why interest rates are being raised. We therefore maintain our pro-equity stance in the mixed asset strategies. While there may be periods of volatility, uncertainty is the friend, not foe, of investors: long-term returns are improved by buying at times of uncertainty.
- It is also likely that some companies will miss their earnings targets (or fail to be sufficiently upbeat in their guidance) and face periods in 'investment purgatory' as a result. This is challenging for fund managers, but the negative impact can be ameliorated by a strong investment process: knowing your companies well and conviction are important, as is the challenge of colleagues if the original investment thesis is starting to unravel. We have developed our sustainable investment process over many years, and it has been effective in various economic and market conditions. While we are always learning and will evolve it where necessary, we have confidence that it will continue to serve our clients well.
- We remain cautious on government bonds. This reflects both the waning impact of QE and the bounce back in economic growth. There is scope for US treasuries to settle above 2%, with real yields moving higher and yield curves to steepen. However, on a secular basis we remain in a relatively low growth phase – despite technological advances. We cannot buck the long-term impact of ageing societies, nor the bills that will need to be paid for Covid and preparing for the next pandemic. In the UK this means more of our national spending going to the NHS – and more issuance of government debt. Credit generally outperforms government bonds – with the caveat that when it underperforms, the magnitude can be meaningful; for long-term investors the balance of outcomes sits firmly in favour of credit. However, credit risk is not something that should be taken unthinkingly, and it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.
- As a final point, in the RLAM Outlook 2022 document (described below), the article on sustainable investing refers to unhelpful regulatory changes and cites the EU's Sustainable Finance Disclosure Regulation (SFDR) and its taxonomy of suitable investments as an example of over-prescriptive regulations. It is interesting to note, therefore, that EU member states are currently at odds about whether nuclear and gas-fired power generation should be considered 'sustainable' in the taxonomy. The proposal comes from France (which generates 70% of its power from nuclear reactors) and is opposed by Austria and Germany among others – Germany shut down the last of its nuclear power stations at the end of last year. This is not the place to debate the rights and wrongs of the proposal – however, we note that it isn't helpful for regulations that are intended to help investors to become politicised or be endlessly debated once in place.

Find out more

- A record number of current and prospective clients and consultants joined us online for the *2021 RLAM Investment Series* (our annual client conference) between 1 and 5 November 2021. Fund managers and other in-house specialists addressed the macroeconomic environment and prospects for different asset classes, and the issues that they consider in managing their funds. There were also sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. All the sessions are available to watch on demand – please visit the RLAM Digital Insight Hub.
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2022 document, and regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk

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