ROYAL LONDON SUSTAINABLE MANAGED INCOME TRUST

Quarterly Report 30 June 2021

For professional clients only, not suitable for retail investors

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Top ten holdings

	Trust (%)
Aviva 6.875% 2058	1.5
Quadrant Housing 7.93% 2033	1.2
Co-operative Bank 4.75% 2021	1.1
HSBC Bank 5.375% 2030	0.9
Penarian Housing Finance Plc 3.212% 2052	0.9
Harbour Funding 5.28% 2044	0.9
First Hydro Finance Plc 9% 2021	0.9
PRS Finance Plc 1.5% 2034	0.9
HSBC Bank 5.844% VRN Perpetual	0.8
Income Contingent Student Loans 2058	0.8
Total	**10.0**

Trust data

	Trust	Benchmark[1]
No. of stocks	300	1,173
Fund size	£227.6m	-
Duration[2]	7.8 years	7.8 years
Gross redemption yield[3]	2.03%	1.46%
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

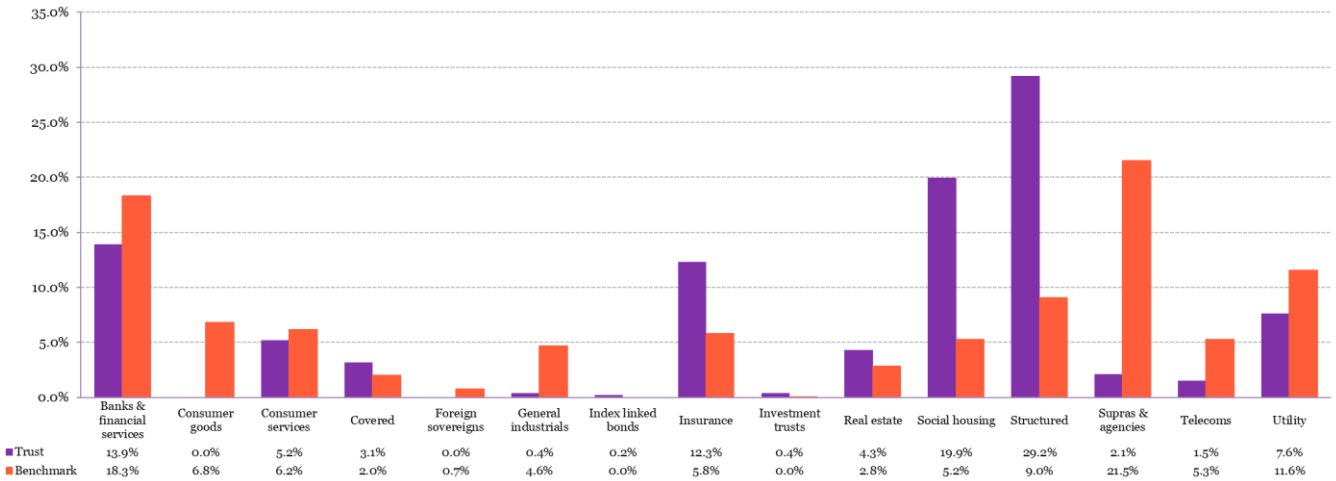
	Trust (C Acc)(%)	Benchmark[1] (%)	Relative (%)
Q2 2021	**2.26**	**1.71**	**0.54**
Year-to-date	-1.05	-2.47	1.42
Rolling 12 months	4.17	1.74	2.43
3 years p.a.	5.75	4.65	1.10
5 years p.a.	5.31	3.95	1.36
Since inception p.a. 07.12.2012	5.40	4.74	0.66

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



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

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Executive summary

- India was a particular concern during the second quarter, with daily new case numbers hitting new records for any country. The 7-day average of new cases fell in the US and Euro area during April, though continued to rise in Germany; social distancing decisions were mixed. A state of emergency was announced in parts of Japan (incl. Tokyo and Osaka). Meanwhile, the EU's vaccination programme made headway and Commission President von der Leyen said that the EU will have enough doses to vaccinate 70% of adults in July.
- Sustainable Managed Income performed well in the quarter, outperforming broad sterling credit markets. This primarily reflected three factors: the overweight allocations to structured bond; the overweight position in subordinated financials, and a low weighting in supranational bonds.

Market overview

- The MSCI World Index posted healthy returns of 7.88% through the second quarter of 2021. Performance was strong throughout, although May was slightly less positive than the preceding and following months and was markedly more volatile. Regionally, Japan was again the only market to post negative returns in sterling terms (-0.33%) while the US (8.9%) continued to lead major equity market returns, followed by Europe ex. UK (8.16%), the UK (5.81%), and emerging markets (5.08%).
- Growth returned as the main driver of performance in the quarter; the MSCI World Growth Index returned 10.94% for the quarter versus 4.9% for the MSCI World Value Index. The outperformance of growth was driven by the information technology sector, which grew by 10.6%, leading global sector returns. Energy (9.6%) and healthcare (9.5%) were the next best performing sectors, while financials, the second strongest sector in the first quarter, was the sixth best of 11 MSCI sectors in the second quarter, providing returns of 6.42% to investors.
- In UK bond markets, after a first quarter focused on rising inflation expectations and a corresponding increase in government bond yields, the benchmark 10-year gilt yield fell from 0.85% to 0.72% over the quarter: the gilt market returned 1.70% on an all maturities basis (FTSE Actuaries). In sterling investment grade credit, the market returned 1.71%. The average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) tightened from 0.96% to 0.91%. All sterling credit sectors produced positive returns during the quarter. Lower risk areas such as supranationals and covered bonds lagged the wider market, while sectors such as real estate and telecoms performed relatively well. Financials performed broadly in line with the market, but subordinated debt again outperformed. With gilt yields falling slightly, longer maturity bonds outperformed shorter dated, while BBB and A rated bonds outperformed AAA and AA issues.
- The Brazilian real was the strongest currency in the quarter gaining 11.8% against the (US) dollar, however major currencies were largely sedentary in comparison. The euro strengthened by 0.83% versus the dollar, while sterling saw no significant movement. The Australian dollar was the period's weakest currency, losing 1.61% against the US dollar for the quarter.
- Commodities extended their rally, leading cross-asset returns. Oil prices continued to recover strongly and were up 50% year-to-date, reaching their highest levels since October 2018 as the reopening trade sustained and blockages in supply chains continued to impact prices. The price of Brent crude oil rose by 18.2% to more than $76 a barrel, while copper and gold also gained value; copper was up 7.2% for the quarter, and gold prices grew by 3.5% to $1,791/oz.

Performance and activity

- The fund performed well in the quarter, outperforming broad sterling credit markets. This primarily reflected three factors: the overweight allocations to structured bond; the overweight position in subordinated financials, and a low weighting in supranational bonds. Our holdings within the structured sector performed well. One example was **Thames Water**, where we particularly like the long-dated Thames bond which is often overlooked by investors. Our view remains that the bond's yield premium vs shorter dated Thames bonds and senior position in the capital structure offers our clients attractive exposure to longer cash utility cashflows. **Finance For Residential Social Housing** was another strong performer over the quarter. The bond, whilst not easily modelled on Bloomberg and relatively illiquid, offers strong collateral and an attractive yield – above that of many unsecured BBB bonds despite its AA rating.
- 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). A takeover offer for Morrisons (not held in the funds) illustrates why we like strong covenants and security. 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 upside when issuers want to access assets that part of a secured issue. During the quarter, **Broadgate** announced

that they were removing 100 Liverpool from their security pool, and as a result, have had to prepay a number of bonds to ensure that the underlying LTV is maintained. This latest news forms part of a continuing trend of Broadgate repaying parts of structure (we saw similar prepayments in 2018 and 2019), and represent a positive dynamic for us of being in a structure that issuer is looking to unwind over time.

- 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.
- There was further issuance of Green and Sustainability bonds in the quarter. Whilst we welcome the greater recognition of the climate challenge and the higher focus on ESG we do not believe that all Green or Sustainability bonds offer value or clarity of objective. We will continue to focus on integrating ESG risks and to add incremental value in overlooked areas of the market. During the quarter we added a new issue from **Beyond**, which provides 15,000 homes, predominantly in the Tees Valley and North Yorkshire, and **Blend**, a social housing debt aggregator that enables smaller housing associations to access capital markets. The Blend deal size was not large but was attractively priced and is a reminder that a small issue size does not imply poor quality. We also looked for opportunities to add to water exposure given the regulated nature of the industry and the societal benefit these companies bring, with examples during the quarter including **Yorkshire Water**. Switch activity always remains a source of incremental portfolio enhancement. During the quarter we switched structured bonds from **Anglian Water** into **Freshwater Finance** – these being the same underlying company with only a slight difference in the risk profile of the bonds, but offering a higher yield.
- 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 (banks focused on SME and retail lending).

Outlook

- There may be short-term challenges if new strains of Coronavirus spread quickly, however central banks remain firmly committed to supportive monetary and fiscal policies.
- Despite a likely short-term spike in inflation, 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 be a long-lasting *deflationary* force as technology reduces our dependence on finite physical resources. 2021 could be like 2009, which was a cyclical/value market as economies normalised after the financial crisis: 2009 was also a year of inflation concerns, as quantitative easing and an economic recovery kicked in. This of course proved to be incorrect and 10 years of subdued inflation followed. There are of course critical differences between 2021 and 2009: in 2009 stimulus was used to prop up the banking sector, whereas today it is being used to feed consumption. Equally, back in 2009 central banks wanted to keep inflation down, now they want to see higher inflation. Still, the point stands.
- Easing inflation will generally benefit 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. This can be seen in our turnover figures, which in the last 12 months is about 10% for the equities we own, suggesting an average holding period of 10 years. And what we have seen historically in our performance is that while market trends ebb and flow in our favour, fundamentals do dominate over the long term, and these will remain the key drivers of our portfolios.
- In sustainable credit exposure, we believe that the additional yield available more than compensates for the risk of default and hence believe that credit will outperform government bonds over the medium term. However, we recognise that idiosyncratic risk – such as increased merger and acquisition activity – cannot be ignored.

A long history of sustainable investing

- You can find more information on our sustainable funds and our views on sustainable investing and other ESG-related issues at www.rlam.co.uk.

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