ROYAL LONDON SUSTAINABLE STRATEGIES

Quarterly Report 30 June 2021

For professional clients only, not suitable for retail investors

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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.
- The equity-only and mixed-asset funds outperformed this quarter, helped by equity markets moving away from the 're-opening trade' that has dominated markets since November, and starting to look more at individual companies and their fundamentals.
- **Sustainable Managed Income** and the credit portfolios of the mixed-asset funds 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 Q2; 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% in Q2, leading global sector returns. Energy (9.6%) and Health Care (9.5%) were the next best performing sectors, while financials, the second strongest sector in Q1, was the sixth best of 11 MSCI sectors in Q2, 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%.
- The Brazilian real was the strongest currency in the quarter gaining 11.8% against the (US) dollar in Q2, 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 USD 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 in Q2, 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 – sustainable equity strategies and mixed-asset equity portfolios

- Our 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.
- While the Sustainable funds have different mandates, risk profiles, asset mixes and geographical exposures, equity exposure is driven by the same underlying team, philosophy and process. Many of our key stocks will be held across multiple portfolios.
- **Adidas** was a major contributor to performance. The shares had lagged in the first quarter on the Chinese government insisting the removal of Adidas from various e-commerce platforms following its statements around not using cotton from the Xinjiang region due to accusations of forced labour. However, this does not seem to have had a material impact on overall Group sales, with products being relisted, while the company announced a strong set of results, all of which helped reverse the earlier underperformance. **St Modwen**, one of our longest standing holdings, was another positive. It is an urban regenerator working on brownfield sites to develop housing and warehousing for broader use in the economy. During

the quarter it received a bid from private equity house Blackstone, which was subsequently increased in late June. **NovoNordisk** was another positive for the fund. Diabetes and weight management remain societal issues and we see the company – the world's largest producer of insulin – as part of dealing with this better over the long term. The shares performed well in the quarter as it had its weight management drug approved by the US Food and Drug Administration (FDA) – the first such treatment the FDA has approved since 2014. Finally, one trend we have seen with the end of the 'reopening trade' was a rebound from technology stocks, with our holdings in **Adobe** and **Intuit** adding to performance, helped by strong results at both. Against this, our exposure to **Phillips** was negative. The firm recalled a ventilator component and although there are no reports of this causing any issues prior to recall, the market took a 'shoot first' approach given the potential for litigation. Another holding, **Prudential**, also saw poor performance as the market reacted negatively to a delay in the demerger of its US business.

- **Sustainable Leaders** had a strong quarter, returning 9.3% against benchmark return of 5.6% on a net of fees basis for C Acc share class. In addition to long-time holding St Modwen, it used the flexibility allowed to hold Adidas and NovoNordisk. The holding in Prudential was a small detractor.
- The **Global Sustainable Equity Fund** also outperformed its benchmark over the quarter returning 11.4% against benchmark return of 7.3% on a net of fees basis for the M Acc share class. The fund benefitted from its exposure to Adidas and Novo Nordisk, as well is its tech exposure in Adobe and Intuit, although exposure to Phillips did detract from returns.
- **Sustainable World**: The fund had a strong quarter, returning 9.5% against a peer group average return of 4.9% on a net of fees basis for the C Acc share class. It benefitted from its exposure to Adidas and Novo Nordisk, as well is its tech exposure in Adobe and Intuit, although exposure to Phillips did detract from returns.
- **Sustainable Diversified**: The fund had a strong quarter, returning 6.6% against a peer group average return of 3.6% on a net of fees basis for the C Inc share class. It benefitted from its exposure to Adidas, St Modwen and Novo Nordisk, as well is its tech exposure in Adobe and Intuit, although exposure to Phillips and Prudential did detract from returns. The fund's fixed income exposure was positive for returns, helped by its bias towards structured bonds.
- **Sustainable Managed Growth**: The fund had a strong quarter, returning 4.1% against a peer group average return of 2.5% on a net of fees basis for the C Acc share class. It benefitted from its exposure to Adidas, St Modwen and Novo Nordisk, as well is its tech exposure in Adobe and Intuit, although exposure to Phillips and Prudential did detract from returns. The fund's fixed income exposure was positive for returns, helped by its bias towards structured bonds.

- We feel optimistic for the remainder of the year. While markets can be unpredictable, we believe that markets are more balanced now in the aftermath of the rotation. We think the window of opportunity for buying Covid recovery stocks has closed, and we are not yet convinced about the arguments for inflation returning in the long term. As a result, buying more of what we own at lower prices makes more sense to us than chasing market trends. Notable trades this quarter included:
  - **Leaders**: we sold out of our position in **Ansys**, which offers high-end engineering and simulation software. The shares had performed very well, but while we continue to like the stock, we have limited capacity for non-UK holdings in this fund, and preferred to switch into **ThermoFisher**¸a US laboratory supplies company that is well placed to benefit from increased spending in areas such as biotechnology and life sciences.
  - **World**: we initiated a new position in **Schneider Electric**. The French company is highly aligned with themes such as electrification and industrial efficiency. As a leading component manufacturer, Schneider will be a key part of the supply chain for those looking to expand renewable energy capabilities. We often look for this sort of investment – where perhaps the 'obvious' choice of companies may be expensive, but looking at those that offer complementary products and services are relatively cheap. We also added a **Sika** to the portfolio. The Swiss chemicals company produces chemicals that help make the construction industry more efficient. Construction is typically a poor sector in terms of carbon footprint, and 70% of Sika's products are focused on improving this. The company is also well placed to be a prime beneficiary of infrastructure spend such as the US $2trn investment programme announced in April.
  - **Global Sustainable Equity**: We added to our position in **Trane Technologies** in the US, a global leader in heating, ventilation and air-conditioning (HVAC) systems and in refrigerated transport. Its solutions bring efficient and sustainable climate innovations to buildings, homes and transport. We see an attractive growth outlook for the company and room for margins to expand over the coming years. We also initiated new positions in Schneider and Sika.
  - **Diversified**: We have the flexibility to increase our non-UK exposure, so used this to add several positions during the quarter. As well as Schneider and Trane Technologies, we added to the holding in US rail and freight supplier **CSX.** The company has been making efficiency improvements and when it comes to transporting bulk goods, rail has environmental benefits over road.

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- **Managed Growth**: We have the flexibility to increase our non-UK exposure, so used this to add a holding in US rail and freight supplier **CSX.** The company has been making efficiency improvements and when it comes to transporting bulk goods, rail has environmental benefits over road.

Performance and activity – Managed Income strategy and mixed-asset sustainable credit portfolios

- 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.
- **Sustainable Managed Income** and the credit portfolios of the mixed-asset funds 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 **Wessex Water**, and **Yorkshire Water**. One notable disposal of note during the quarter was **Mitchells & Butler**. While the financials remain supportive, concerns over potential board structure and governance changes means that this no longer passes our assessment as an ESG leader.
- 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).

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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.
- A lot of client conversation in recent months have been about growth or value investing styles, their merits and the impact on sustainable investing. Equity markets saw a rotation out of growth and into value stocks from November 2020 into 2021. There are now signs that this trend has reversed once more. RLAM's Sustainable funds take a long-term view: we are looking at companies that may benefit from trends that play out over multiple years and even decades. This is what drives our investment choices and ultimately performance, rather than a preference for growth over value.
- With these various factors, we believe that equities will outperform bonds over the year. We feel that forecasts of strong GDP growth in the coming months aren't fully reflected in earnings forecasts yet, particularly for more cyclical companies, so sectoral rotation may persist in the short term. Beyond that, there are signs that we may be in the later stages of a long-term bull market that started after the global financial crisis in 2009. These include the recent Deliveroo IPO, the rise of SPACs (special purpose acquisition companies – the 'new' driver of global M&A) and the Gamestock phenomenon. However, these later stages can go on for a while, particularly with such widespread central bank support. We have therefore maintained our pro equity stance in the mixed asset strategies as we remain positive on the medium- to long-term outlook of the specific companies we invest in.
- 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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ASSET MANAGEMENT

IMPORTANT INFORMATION

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