ROYAL LONDON SUSTAINABLE WORLD TRUST

Quarterly Report 31 March 2021

For professional clients only, not suitable for retail investors

CONTENTS

ROYAL LONDON SUSTAINABLE WORLD TRUST

Top ten holdings

	Fund (%)
Microsoft	3.0
Koninklijke Philips N.V	2.9
Texas	2.8
AstraZeneca	2.7
Experian Group	2.6
Adidas	2.6
Agilent Technologies	2.5
Thermo Fisher Scientific Inc	2.5
Taiwan Semiconductor Manufacturing Co	2.5
ASML Holding	2.5
Total	**26.6**

Source: RLAM, based on the A Inc share class.

Fund data

	Fund
No. of stocks	261
Fund size	£2,322.7m
Launch date	21.09.2009

Performance

	Fund (C Acc) (%)	Peer Group[1] (%)	Relative (%)
Q1 2021	**-2.35**	**1.85**	**-4.21**
Year-to-date	-2.35	1.85	-4.21
Rolling 12 months	27.71	26.29	1.42
3 years p.a.	16.09	6.38	9.72
5 years p.a.	16.26	7.49	8.77
10 years p.a	14.20	6.16	8.05
Since inception p.a. 21.09.2009	13.82	6.78	7.05

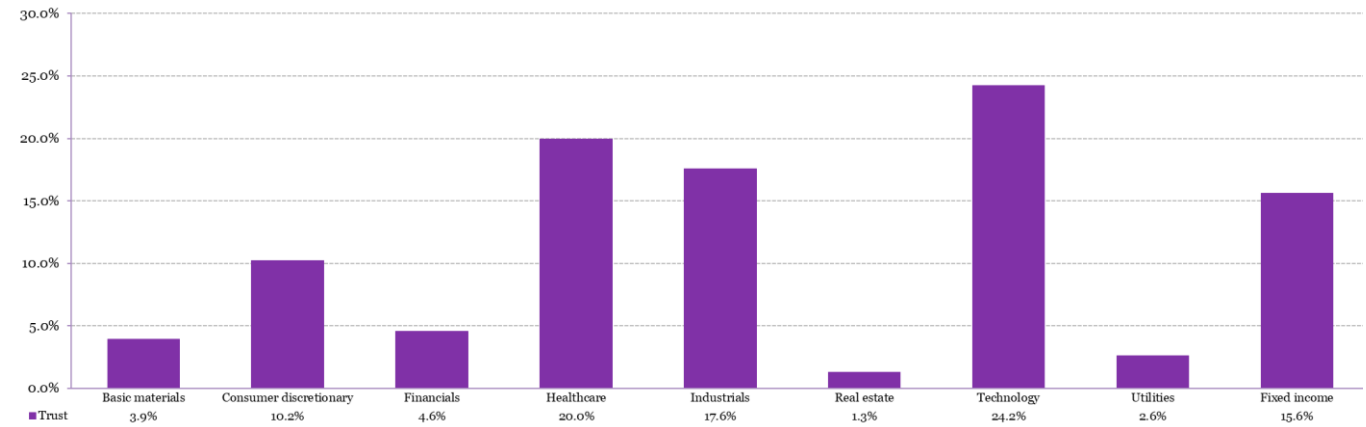
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated.

Source: RLAM, gross of standard management fees.

[1]Peer Group: IA Mixed Investment 40-85% Shares sector.

Sector breakdown



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

ROYAL LONDON SUSTAINABLE WORLD TRUST

Executive summary

- The year started with cautious optimism about vaccination programmes that offered the prospect of the reopening of the global economy and a recovery from mid-year, tempered by concerns about new strains of Covid-19 and extended lockdown measures. This balance shifted sharply as vaccine rollouts exceeded expectations in the UK and US. Meanwhile, the Democrats' victory in the Senate runoffs in January and President Biden's $1.9tn fiscal package increased investors' expectations of a strong US recovery, leading to higher and steeper yield curves. In addition, there were concerns that friction in global supply chains and positive base effects will lead to higher inflation.
- The two primary equity market trades this quarter (and indeed since 9 November – 'vaccine day') have been Covid recovery and reflation. The Covid recovery trade is to buy those stocks most affected by the pandemic, including retail, airlines, pubs, cinemas and certain types of property. It also involves selling the companies that benefited from the online shift last year; the 'stay-at-home' trade. The reflation trade is to buy commodities and financials, both of which benefit from inflation, and to sell growth stocks, which as long-duration assets are most impacted by rising bond yields, themselves a consequence of signs of higher levels of inflation. These trades resulted in a rapid and significant rotation in equity markets on a grand scale.
- As a result, the fund underperformed this quarter. These are not ideal conditions for sustainable investing. Healthcare and technology-oriented funds like ours have struggled against funds with significant exposure to energy, industrial commodities and financials. We also prefer companies with stronger balance sheets and this also counted against us this quarter as more cyclical and/or leveraged companies delivered the best returns. While acutely aware that underperformance is disappointing, we hope investors will see it in the context of the strategies' strong performance over three and five years. We had anticipated that the immediate Covid recovery would be challenging. However, we strongly 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.
- Perhaps surprisingly given the weak relative performance, there were few stock-specific negatives. The companies that we own have performed reasonably well operationally, with perhaps the most notable trend from them being the need to invest more in their businesses. Markets do not generally like investment, even if it leads to a more valuable business in the long run, as it usually requires the downgrading of shorter-term profit forecasts. We take the opposite view, but time will tell if these investments will pay off. London Stock Exchange was particularly affected by this issue. In its first update since its acquisition of Refinitiv, the Thomson-Reuters data business, instead of the upgrades that the market was expecting, the company announced that increased investment will be needed to realise the full synergies of the deal.
- The fund's credit exposure performed well in the quarter, significantly outperforming the benchmark, although total returns were negative due to the rise in gilt yields. This primarily reflected three factors: the overweight allocations to structured bonds, including social housing; the overweight position in the insurance sector, particularly subordinated insurance, and security selection within the banking & financial services sector; and the allocations to bonds rated BB and below and to unrated bonds.
- If 2021 turns out to be like 2009, we may have some headwinds in the funds for a while longer. That said, in recent meetings with the companies that we invest in one thing is clear: sustainability is becoming a significant business opportunity for them that didn't exist even last year. Whether this be providing sustainable chemicals, auditing supply chains for environmental performance or providing environmental, social and governance (ESG) data to fund managers, sustainability is alive and well in the corporate world and this will only benefit our funds over time.

Market overview

- Global stock markets continued to rise in the first quarter. The MSCI All Countries World Index (ACWI) rose +3.5% in sterling terms. Among the major regions, the UK, US and Europe excluding the UK were the strongest markets, whereas Asia Pacific excluding Japan, emerging markets and Japan were more pedestrian. However, the dispersion in returns resulted mostly from sector rotation. The energy sector was up 16.8% and financials 10.4%; whereas IT was only up 0.7%, and healthcare and consumer staples down -0.5% and -1.8%, respectively (MSCI ACWI in sterling terms).
- As a result of these shifting expectations, government bond yields rose across all leading markets. The benchmark 10-year gilt yield rose from 0.20% to 0.85% over the quarter, leading gilts to return -7.24% on an all maturities basis (FTSE Actuaries). This, however, only takes gilt yields back to the level at which they started 2020. Credit markets were a relative bystander with investment grade spreads broadly unchanged over the quarter. 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 0.99% to 0.96%.
- Sterling was one of the strongest major currencies over the quarter, strengthening another 1.1% against the US dollar, which

was itself more robust after a period of weakness. Sterling also strengthened against the euro (+4.1%) and against the yen (+7.1%). This tempered the returns for sterling investors in global equities.

- Following a very strong fourth quarter, oil prices continued to recover strongly with the global economy continuing to grow and ongoing discipline from OPEC. The price of Brent crude oil rose by +22.7% to nearly $63 a barrel. Copper also continued to strengthen as economic activity recovered, rising +13.4% over the quarter to reach a multi-decade high. The strategies have no exposure to oil & gas and basic materials.

Performance and activity – equity exposure

- 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.
- The two primary equity trades this quarter (and indeed since 9 November – 'vaccine day') have been Covid recovery and reflation. The Covid recovery trade is to buy those stocks most affected by the pandemic, including retail, airlines, pubs, cinemas and certain types of property. It also involves selling the companies that benefited from the online shift last year; the 'stay-at-home' trade. The reflation trade is to buy commodities and financials, both of which benefit from inflation, and to sell growth stocks, which as long-duration assets are most impacted by rising bond yields, themselves a consequence of signs of higher levels of inflation. These trades resulted in a rapid and significant rotation in equity markets on a grand scale.
- These are not ideal conditions for sustainable investing and the fund underperformed this quarter. Healthcare and technology-oriented funds like ours have struggled against funds with significant exposure to energy, industrial commodities and financials. Performance was impacted by the fund having zero exposure to the oil & gas sector, which performed well as oil prices rose over 22%, and basic materials, which rose as industrial production continued to grow 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. We also prefer companies with stronger balance sheets and financial profiles, and this also counted against us as more cyclical and/or leveraged companies delivered the best returns over the period.
- Perhaps surprisingly given the weak relative performance, there were few stock-specific negatives – underperformance was largely down to the sector rotation described above. The companies that we own have performed reasonably well operationally, with perhaps the most notable trend from them being the need to invest more in their businesses. Markets do not generally like investment, even if it leads to a more valuable business in the long run, as it usually requires the downgrading of shorter-term profit forecasts. We take the opposite view, but time will tell if these investments will pay off. **London Stock Exchange** was particularly affected by this issue. In its first update since its acquisition of Refinitiv, the Thomson-Reuters data business, instead of the upgrades that the market was expecting, the company announced that increased investment will be needed to realise the full synergies of the deal. We remain committed to this holding, believing the acquisition will prove successful over time, but the market has been unforgiving and it may take some time for the company to regain investors' full trust.
- Other companies issued more conservative guidance than the market had been expecting, again referencing the need for additional investment, and duly underperformed: **Sage**, **GlaxoSmithKline** and **Unilever** were all affected by this. To some extent, this simply reflects a shift in market sentiment. To illustrate this, **Adobe** reported recently and forecasts were upgraded, yet the stock traded lower on the news. It is never wise to believe that the market's reaction to news was 'wrong'. However, we are long-term investors and saw nothing in these statements to cause concern, and we believe that these companies will come back into favour in due course.
- **Adidas**, the global sporting goods and 'athleisure' brand, also detracted from performance over the quarter as it recommitted to not sourcing cotton from the Xinjiang region of China, where it is reported that Uighur forced labour is used in contravention of modern slavery laws. This has led to a backlash from state-controlled media in China and there are concerns that it will impact the company's prospects in a key market for growth. A number of companies are affected. Again, we are not overly concerned by this and see it as a regular geopolitical hazard for global companies. In fact, as committed sustainable investors, we applaud the company for its stance and feel reassured that it takes this important issue seriously.
- While the fund is overweight in equities relative to peer groups, relative performance was affected by the sector rotation described above. With no exposure to the oil & gas or basic materials sectors and limited exposure to financials, all on sustainability grounds, the fund was principally affected by the Covid recovery and reflation-based sector rotation. Significant stock-specific underperformance came from London Stock Exchange and Adidas.
- Despite the sector rotation, we did not materially change our positioning. We think the window of opportunity for buying

ROYAL LONDON SUSTAINABLE WORLD TRUST

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. An example is **TSMC**. Semiconductor manufacturing is highly technical with huge barriers to entry and is an area where we expect demand to increase significantly in an increasingly digital world. We have held TSMC for some time and have used recent weakness, which is nothing to do with the health of the business, to buy more stock at lower prices. Otherwise, we reduced our holding in **Roche**, the Swiss pharmaceutical company. Other stocks present clearer medium-term opportunities, such as **Schneider Electric**, in which we started a new position. The French company is highly aligned with themes such as electrification and industrial efficiency.

Performance and activity – credit exposure

- Nearly all sterling credit sectors outperformed gilts during the quarter but, with the rise in gilt yields, total returns were negative across the board. The financials sectors performed strongly, particularly subordinated insurance and covered bonds, as did structured bonds. In contrast, the real estate, utilities and healthcare sectors were notably weak. Supranationals performed surprisingly strongly given the more 'risk on' environment, but this was largely driven by positive duration as shorter-dated bonds notably outperformed longer-dated issues. Otherwise, ratings had a mixed effect: while the AAA band outperformed AA and A rated bonds, BBB rated bonds also outperformed.
- A notable feature of the market was the continued unwinding of the effects of the Bank of England's (BoE) Corporate Bond Purchase Scheme, which played a major role in the recovery of the sterling credit market following the Covid-19 crisis. The BoE bought an additional £10bn of corporate bonds under the pre-existing scheme to support market liquidity. However, the scheme excluded many asset-backed securities (ABS) and all financial bonds, distorting market valuations as eligible bonds (representing c. 28% of typical credit indices) strongly outperformed the wider market. Although the programme was completed on 1 October, these distortions continued to unwind during the first quarter.
- The credit exposure performed well in the quarter, significantly outperforming the benchmark, although total returns were negative due to the rise in gilt yields. This primarily reflected three factors: the overweight allocations to structured bonds, including social housing; the overweight position in the insurance sector, particularly subordinated insurance, and security selection within the banking & financial services sector; and the allocations to bonds rated BB and below and to unrated bonds. Each of these factors was to some extent driven by the unwinding of the distortive impact of the BoE Corporate Bond Purchase Scheme as these parts of the market were excluded. This was as we had anticipated as this effect was also observed in the quarters following the scheme's original application in 2016. Otherwise, relative performance benefitted from being underweight in the utilities and telecoms sectors, and in ultra-long-dated bonds. Notably, we had previously precluded investment in bonds of **Credit Suisse** on governance grounds – this was beneficial as the Swiss bank was hit by a $4.7bn loss from its exposure to the Archegos hedge fund as well as the failure of Greensill Capital, leading Moody's and S&P to put its bonds on negative watch.
- 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.
- There were no defaults in our portfolios during the quarter and across the corporate sector failures remain at low levels. While defaults are likely to increase from the current very low levels as we transition back to more normal economic conditions and government support is withdrawn, we believe that our sterling credit strategies are well positioned for this. Over the last 12 months 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. Our orientation towards bonds with security has been highly valuable in enabling this, providing a natural justification for regular meetings. The holders of unsecured bonds do not get the same opportunities, particularly if the bonds have weak covenants, leaving them exposed to the vicissitudes of the market and whims of management teams.
- Following weak issuance in January and February, with levels at around 50% of last year, sterling investment grade supply increased sharply in March, reaching the highest level since June 2020. Financials led the way as non-UK banks continued to issue in sterling, along with a number of non-bank financials. We actively participated in new issues over the quarter.
- Reflecting the strength of our lending position, during the quarter we sold **Haven Funding** (social housing) debt back to a borrower at a significant premium to existing pricing, allowing the borrower to release assets from our strong covenants and borrow elsewhere if needed. In addition, we sold the last of our gas distribution bonds in the portfolios (**Southern Gas Networks**) reflecting our view that the sector does not adequately price in the stranded asset risk on gas distribution

assets. Sales of gas distribution companies in recent quarters have enabled us to improve the carbon footprint of the funds to materially lower levels compared to typical credit indices, improving sustainable outcomes within the funds while not compromising on yield potential.

- 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

- The success of the UK and US vaccination programmes promises a return to more normal social and economic conditions by the third quarter with a strong economic recovery in the second half of the year. In the meantime, while there may be short-term challenges if vaccine nationalism affects ongoing rollouts or new strains spread quickly, 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, we believe the point stands.
- With these various factors, we believe that equities will outperform bonds over the year. We feel that forecasts of GDP growth of 6.5-8% 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, including 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.
- In sustainable credit, the recovery in spreads over the last 12 months has been remarkable and they are now towards the lower end of their normal range, so the potential for further tightening is limited for the wider market. However, there are pockets of value in some sectors and securities that will reward diligent active managers. In addition, income generation will become an increasingly important source of overall returns, as excess income is compounded over time. Our strategies are well positioned for this, since we have long maintained a yield advantage over the index by investing in assets that we consider undervalued. A good example of this is social housing, where our preferences have been in the higher yields parts of the sector in which we found more value. Crucially, this yield advantage can be realised without compromising security, which the market often undervalues. We believe that our approach of capturing excess income, while mitigating risk through strong covenants, a preference for secured bonds, and security and portfolio diversification is ideally suited for the challenges that may lie ahead.
- We believe that many of the companies we are invested in will come out of this crisis even stronger than they went in. Recent company meetings suggest that many of our holdings are performing well in the real world, whether they're helping to reduce carbon footprints in global supply chains (Intertek), providing natural specialty chemicals (Croda International) or ESG data and indices (London Stock Exchange). Despite the underperformance of the equity strategies during this period, we are more convinced than ever that sustainable investing will continue to flourish and that our funds are well positioned to benefit from this. They are invested in a range of innovative, well-managed businesses with durable competitive advantages and which are supporting the transition to a more sustainable world through key social and environmental trends, such as decarbonisation, digitisation and healthcare.

ROYAL LONDON SUSTAINABLE WORLD TRUST

A long history of sustainable investing

- Our flagship **RL Sustainable Leaders Trust** celebrated its 30th anniversary last year. Meanwhile, the **RL Global Sustainable Equity Fund** recently marked its first anniversary and we extended our sustainable fund range with the launch of the **RL Global Sustainable Credit Fund** on 10 February 2021.
- You can find more information on our sustainable funds and our views on sustainable investing and other ESG-related issues at rlam.co.uk.

ROYAL LONDON
ASSET MANAGEMENT