

# RL Sustainable Short Duration Corporate Bond Fund: one year on...



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Fund  
Manager

## What are the biggest challenges and successes you've had over the last 12 months?

A background of central bank rate hikes and volatile, rising yields is never easy for bond investors. It typically comes with greater recession risk too, so confidence in the quality of your lending decisions, driven by rigorous in-house credit analysis becomes more vital than ever.

But for the fund, this volatility has created opportunity too. We all know that markets can over-react, such as around the collapse of Credit Suisse, when investors extrapolated the Swiss banks specific issues to the wider financial system. Our sustainable process means we didn't lend to a bank with such fundamental governance and control issues, but the wider volatility created opportunities to add to high quality, well capitalised banks that we do like, simply at more attractive levels.

It's great to see that the fund has had a strong first year, with positive one-year Net Fund returns of 5.69%, and good performance relative to the benchmark ICE BoA Sterling Non-Gilt 1-5 year index that has returned 4.30%\*. The key driver of this outperformance has

been sector and bond selection, reinforcing our focus on bottom-up sustainable and financial analysis in managing the portfolio.

## How do you differentiate this fund from other Sustainable funds at Royal London?

We launched this fund because talking to our clients, there was a clear demand for sustainable credit exposure, but end clients didn't want as much interest rate risk. So in that sense, there is nothing revolutionary in terms of how we manage this – with an approach that is largely the same as the all-maturity RL Sustainable Managed Income Trust that we launched over a decade ago.

The difference between the two reflects the additional short duration objective, which does give it some slightly different sector exposures, but using the same underlying team, philosophy and process. Our Sterling Credit team is used to taking a long-term approach and that doesn't change with this fund: it's short duration investing, but long-term thinking.

Of course, the fund is very different to our sustainable equity funds. Due to the differences of our asset classes sustainability manifests in very different ways: the equity team can look at companies focused on innovation, because as shareholders they get to capture those gains if companies succeed. That obviously doesn't happen in our world – we

face the same downside if things go wrong, but not the upside if it goes well. So our focus is about protecting that downside wherever we can, through diversification, security, and companies with more stable, dependable cashflows such as social housing, utilities and infrastructure. All still fantastic sustainable businesses, but reflecting the nuances of credit as an asset class, and a great complement to our sustainable equity offering given the different areas we are targeting.

## What differentiates this fund from other short duration funds?

A typical short maturity sterling credit index is very focused on banks and supranationals, with around a one-third weighting in each. There are clearly some very sustainable businesses within supranationals, but we feel that the yields on offer are far too low, and we can find great quality businesses elsewhere, with more attractive yields and security over assets to better protect us.

And when you look at financials, the sustainable element is really interesting. In many ways having a high weighting in banks is the quick and convenient way to build a sustainable credit fund. Most banks will be well resourced to meet the needs of external ESG rating providers, and will look very attractive on a scope 1 and 2 emissions basis, but we think there is no substitute for in-house primary

research. Our more rigorous sustainable approach has led to lower financials exposure, helping us to avoid the likes of Credit Suisse, while pointing us towards more retail and SME focused banks, which we think is a far more credible outcome.

## Social housing is in many of your funds. Why is it so interesting?

Social housing is a core element in all our sterling credit funds. It's a sector we know very well, and have been lending to for many years.

We think there is very strong sustainability case for this sector: it houses around six million of the most at need in England, and is building around one in every four new homes. That talks to a social purpose, and an ongoing need for capital. These companies are not-for-profit, making them a fantastic opportunity unique to debt investors. And as well as supporting a great sector, we often lend with security over assets, providing greater downside protection to clients. In fact, the majority of our shorter-dated social housing bonds are older style bonds, which come with stronger covenants compared with more recent issuance, giving even greater protections.

Social housing makes up less than 1% of the short-dated sterling credit market. Our weighting is nearer 10%, a clear differentiator, which demonstrates our conviction on the valuation and sustainability of the bonds we own in the sector.

## Water companies have been in the news. Are you a buyer or a seller?

Water companies have been in the news a lot, but a key part of our role is looking beyond headlines to assess the fundamentals. Water is a highly regulated industry providing an essential service. The English water sector and its provision of clean drinking water, and wastewater services is often taken for granted, but our analysis shows that it is on a par or even

ahead of a range of other countries. However, this does not preclude us from ensuring that we do our due diligence on each company.

We won't buy a company that fails our criteria even if it is a great sustainable sector. So we apply the same process as we do everywhere else: what do the financials look like? How is the company managed? What is it doing about leakage, cost-of-living, sewage dumping?

Our Credit and Responsible Investment teams have probably spent more time looking at the water sector than any other in the last decade. We've engaged with companies, the regulator and developed our own methodology for assessing these, the WatSit score. There are a lot of things water companies need to do better, but a deeper dive shows us that when compared to international peers, English water companies are doing pretty well operationally and keeping bills relatively low.



ESG integration in UK  
Water companies

They are leaders in areas like net zero and were thinking about biodiversity and climate change well before most other businesses. They have very long-time horizons, planning in decades. These companies will need debt markets to support their continued investment at the higher levels that society now wants. That gives us leverage when we engage. So while recent media focus on the sector has been disappointing, we would see this as an opportunity to add to positions at more attractive yields, having courage in our convictions.

## What role does infrastructure play for this fund?

Infrastructure is so important for creating a sustainable future. While it may not be as exciting as other areas focused on innovation, it is still absolutely vital for achieving society's goals, such as net zero. For example, building electricity pylons to connect more renewables to the grid is important work that

needs to be done. Infrastructure needs committed capital and creates long-term cashflows. Bond markets are the ideal source of funds for stable cashflow generating assets. Take the Thames Tideway project: a 25km sewer isn't glamorous, but it's essential in helping deal with the growth of London and cleaning up the River Thames. As well as fantastic environmental benefits, lenders benefit from high quality, regulated cashflows, and security over the project, making it a great fit for sustainable bond portfolios.

## Can the next 12 months be as successful as the last?

Given our long-term lending mindset, we're always wary about predicting 12 month returns with any great certainty; however, our successful track record in building and managing credit funds over various cycles should give comfort and optimism to our end investors. What is different right now is the yield on offer on short-dated bonds is very attractive, anchored by the high base rates, and a short duration strategy provides access to these higher levels of income without undue volatility from future interest rate changes.

In addition, our process allows us to target a range of inefficiencies, including the undervaluation of secured debt, and a general overvaluation of the highest profile borrowers, including those with ESG labels. Our research approach remains targeted, looking beyond ESG labels, and providing access to areas with greater scope for value add and true sustainability.

Given the way that we lend, with a focus on diversification and lending structure, we believe the portfolio is also well positioned to protect against any slowdown in economic growth, as well as potentially benefiting from the enhanced yield environment and inefficiencies within the sterling credit markets, all whilst lending to some fantastic sustainable businesses.

## Risk warnings

**Credit Risk:** Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

**Investment Risk:** The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

**Concentration risk:** The price of Funds that invest in a reduced number of holdings, sectors, or geographical areas may be more heavily affected by events that influence the stockmarket and therefore more volatile.

## Efficient Portfolio Management

**(EPM) Techniques:** The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

**Exchange Rate Risk:** Investing in assets denominated in a currency other than the base currency of the Fund means the value of the investment can be affected by changes in exchange rates.

**Counterparty Risk:** The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

## Responsible Investment Risk:

The Fund can only invest in holdings that demonstrate compliance with certain sustainable indicators or ESG characteristics. This reduces the number securities in which the Fund can invest and there may as a result be occasions where it forgoes more strongly performing investment opportunities, potentially underperforming non-sustainable funds.

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For more information about our range of products and services, please contact us.

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