Three years on – Royal London Global Sustainable Credit Fund

The Royal London Global Sustainable Credit Fund was launched in February 2021 and is now celebrating its third anniversary. In this article, we cover the objectives at launch, performance so far, the lessons learned and what comes next for this strategy.

Rachid Semaoune

Fund Manager

Taking it global

The fund was launched thanks to the confluence of two things: first, client demand was increasing with many already using our sustainable range, including our sustainable sterling credit funds, but wanting a strategy that reflected the wider push for global; and second, we had been successfully managing a significant segregated sustainable global credit mandate for some years. It meant we could point to a tried and tested strategy and have a degree of confidence in how we would create the fund and manage it.

This made it quite straightforward in terms of what we wanted this to look like. Launched as part of our Dublin range, we wanted this to be Article 9 compliant, globally diversified, low carbon intensity and using the combination of well-established, proven sustainable and global credit capabilities and expertise.

The Sustainable investment process is fundamentally based on positive screening; looking for companies providing a positive contribution to society through their products and services (the "what") and/or demonstrating leading sustainable practices in the way they operate (the "how") to create a cleaner, healthier, safer and more inclusive world.

A challenging environment to begin with

In the immediate aftermath of the covid pandemic, and with bond yields at or near historic lows, the environment was a difficult one for global credit. Over the first year or so, rising inflation meant that central banks were raising rates while also cutting back or even reversing government bond purchase programmes – all of which helped push yields higher.

In addition to that 'macro' headwind, there were a number of smaller issues. For instance, we had an allocation to sterling credit, mainly in structured bonds which are more common in this market, but the Truss / Kwarteng mini-budget pushed gilt yields higher, leading to negative returns on all sterling assets.

The Ukraine invasion also helped sectors in areas such as oil or commodities, which we will not buy in our sustainable portfolios given their poor sustainable characteristics.

However, market conditions since then have been normal. Even with some underlying yield volatility as markets tried to predict the peak in global interest rates, the yield advantage we had built into the portfolio started to pay dividends. Performance in 2023 and the first months of 2024 was ahead of benchmark, which meant that by the three-year anniversary, we were slightly behind target (to outperform benchmark by 0.75% per annum over rolling three year periods), but feel we are well positioned to move back to that target.

Global benefits

One of the largest advantages of a global credit universe is also a hurdle: its sheer size and scope. From a practical point of view, we focus on the US, European and UK investment grade markets as these account for about 90% of the benchmark. In addition, the sustainable lens we apply for this fund also helps create a more manageable opportunity set, as this filters out companies that are not offering a net benefit to society.

The global flexibility also offers us greater opportunities for diversification as some sectors have greater representation in one jurisdiction than another, meaning that in our view, these different regions are complementary. So for instance, when looking utilities, a large proportion of US utilities include some nuclear power capabilities. We won't include nuclear in our portfolios and hence our utilities exposure is much more biased to European names, as many more of these do not include nuclear. But if you look at areas such as pharmaceuticals and technology, which are essential parts of the move to a more sustainable world, the US dominates. The sustainable test helps us narrow the investible field, while the global nature prevents us having to too great a reliance on one or two sectors.

But although there are these sector or thematic biases in the funds, ultimately we judge each bond on its merits. A great example of this is in the US utilities sector. Many companies in this sector won't pass our sustainable criteria, while Europe tends to have more renewables capacity, but one advantage of being a fixed income investor (over equity) is that sometimes you can buy bonds just focused on one part of a company that meets your hurdles. Topaz Energy is an example of this. It is part of Berkshire Hathaway, which we don't hold in our sustainable funds, but Topaz Solar Farm is a US subsidiary, one of the world's largest solar farms in California. The bonds are secured on those assets and backed by cashflows from this. It's been a great performer for the fund.

The importance of in-house resource

It is possible to build a portfolio of 'sustainable' companies using external research or ratings. But in our view, this is not the best way to do it. There are limitations in coverage, and ratings are often focused at company level rather than issuer level. We will use these ratings as part of our assessment, but not the sole input. This partly reflects the fact that these ratings have their roots in equity assessment – which can then miss the different characteristics in individual subsidiaries – as with the Topaz example – but may miss entire companies if these do not have a public equity listing.

The ease of off-the-shelf labelling or ratings can also be seen in green and sustainable bonds. We are naturally predisposed towards or against these bonds. But we have never bought or ignored a bond because of its label or lack of label. In our view, these bonds get a lot of attention, but ultimately they are more interesting to us because they introduce inefficiency into markets – causing some buyers to be price insensitive. That creates opportunities for active managers.

As well as in-house credit and sustainable analysts, we also have our own Responsible Investment team. This is an invaluable resource which can bring additional expertise to bear. An example of this is in utilities, where a key factor for us is their transition plan. This is a vital element in the overall sustainable assessment, but the unique nature of each company's plan means that an off-the-shelf rating cannot really capture this, and having an independent, in-house assessment of these is a crucial part of our decision-making.

Keeping to our sustainable and investment principles.

Global credit markets are huge – and the opportunity set is so wide, that we have no shortage of bonds that we feel have the right combination of sustainable characteristics, and an attractive yield that we are confident will continue to be paid.

But applying our investment and sustainable principles is essential. An example is financials. From an investment standpoint, we believe that valuations in this area are often attractive. Our focus on sustainability means that our exposure is focused on more retail institutions and typically avoids large investment banks.

This feeds into our overarching aim to build a diversified portfolio of bonds that meet our sustainable criteria and look attractive from a risk / return basis, with that portfolio yielding more than the benchmark.

That final point is really important. In many ways, we take a very simple approach to fixed income investing: we create highly diversified portfolios to help mitigate the potential impact of any default, and build in a higher yield than the benchmark and then aim to compound that over time.

One of the principles of our fixed income team is that we are long-term lenders rather than short-term traders. Although we have now been running this fund for three years, and it has grown to around $400 million, it is still early in the life of this fund. So we'll keep the fund focused on those core principles of creating a yield advantage, having a high degree of diversification and only investing where we are satisfied that our financial and sustainable criteria are met.

Investment risks

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

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.

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.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

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.

Emerging markets risk: Investing in emerging markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Exchange rate risk: Changes in currency exchange rates may affect the value of this investment.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Leveraged risk: The fund employs leverage with the aim of increasing the Fund's returns or yield, however it also increases costs and its risk to capital. In adverse market conditions the fund's losses can be magnified significantly.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

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.

Contact us

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Royal London Asset Management
80 Fenchurch Street,
London EC3M 4BY

For any queries or questions coming from UK or non-EEA potential investors, please contact:

For advisers and wealth managers
bdsupport@rlam.co.uk
020 3272 5950

For institutional client queries
institutional@rlam.co.uk
020 7506 6500

For any queries or questions coming from EEA potential investors, please contact:

Arnaud Gerard
FundRockDistribution S.A.
9A rue Gabriel Lippman
Luxembourg-L-5365, Munsbach
+352 691 992 088
arnaud.gerard@fundrock.com

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