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Liontrust GF Strategic Bond Fund

March 2023 review

Fund managers: Phil Milburn and Donald Phillips

The Liontrust GF Strategic Bond Fund returned 1.0%* in US dollar terms in March. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was 0.1%.

The prevailing themes in later January and throughout February were stronger economic data and the need for higher terminal interest rates in order to conquer inflation. In March the markets' attention obviously shifted to the failure of three banks, Silicon Valley Bank and Signature Bank in the US as well as Credit Suisse in Europe. The write-down of Credit Suisse's Additional Tier 1 (AT1) to zero during the rescue takeover by UBS caused particular chagrin in some corners of the bond market.

To give some background, it was just under 14 years ago that the first contingent capital bank bonds were created. Their initial beginnings arose from exchanges out of banks having other bond-based capital securities that regulators deemed no longer fit for purpose, i.e., did not absorb losses in the way that regulators wanted them to. The name "contingent convertible," or cocos for short, was because under certain contingent conditions (usually a fall in tier 1 equity ratios below a certain threshold) the bond automatically converted into equity. There was huge debate about whether these were bond-like instruments; as time progressed the regulators decided that the cocos were still too bond-like in nature and gradually features have changed such that it is easier for this tranche of the capital structure to absorb losses. The whole point of this is to add extra layers of protection, beyond equity capital, to deposit holders and the taxpayer.

Due to some lazy market conventions the asset class is still frequently referred to as "cocos". It really should be called AT1 (Additional Tier 1 is extra tier 1 capital above and beyond that in equity; tier 1 sounds like the best – it is from a regulator's perspective, from a bondholder's perspective it is the riskiest). Some of the AT1 universe are still cocos (e.g. UK banks) in that when the bank gets stressed the bonds convert to equity. Other parts of the AT1 universe have more onerous terms for bondholders – having write-downs in the bond documentation rather than conversion. These write-downs can be partial or full, and they can be temporary or permanent. "Contingent write-downables" has less of a ring to it but is a more accurate description of these structures.

The documentation for Credit Suisse AT1 had a full and permanent write-down provision. The extraordinary support the Swiss authorities had granted to Credit Suisse enabled the triggering of the write-down of the approximately CHF16bn of AT1. Caveat emptor, the loss absorbing part of the capital structure absorbed losses. One complaint from AT1 holders is valid – why did the SNB/Finma not completely wipe out shareholders? I'm guessing that it was to save face on the international stage and to persuade the board to vote for the deal (saving having to do a temporary nationalisation), but we may never know. The EU and UK authorities were very quick to respond on the Monday after the Credit Suisse rescue weekend saying that they would respect the capital structure; this does not mean that AT1 would have fared any better if an EU/UK bank got into trouble, merely that equity would be completely written off first.

This is not the end of the asset class for AT1; there will, however, be a large reassessment of the risk in the asset class. The demand/supply technical will be horrendous for a few months as forced sellers arise from mandate changes. Ultimately though, you never earn a much higher yield without taking on much more risk. This default, and zero probable recovery (good luck to those suing the Swiss), should be viewed in the context of the high yielding (and frequently high yield rated) nature of AT1.

Our view has always been that the asset class is risky but investable when returns (yields) are approaching equity-like levels, which is generally high single digits. Weightings should be carefully managed, and limited, as members of the banking sector are inherently inter-connected to each other.

Our view is that this is not a systemic crisis; the banks involved have all shot themselves in the foot in some way or other over the last few years, either completely mis-managing the duration of their assets (relative to their liabilities) or having a series of scandals that eroded stakeholder trust. Although legitimate market concerns remain about the asset quality of some US regional banks due to their exposure to commercial real estate lending, deposit flight from the system did slow as the month progressed. It is hard to disaggregate whether deposits moved to money market funds due to "return of capital" or "return on capital"; I would posit the fortnight post SVB failing was mainly the former but outside of that period it is about the latter. By "return of capital" I mean depositors are just worried about getting their money back; any balances above $250k in the US are not insured by FDIC (respectively £85K and the FSCS in the UK). "Return on capital" is about how much more attractive yields are at the very front end of the bond market than on current accounts. Banks have been particularly slow to pass on rate rises to their customers, or, to use market jargon, there has been a low "deposit beta" (rate of interest rate increases being passed through to depositors). As quantitative tightening (QT) continues, some banks are going to have to accept a squeeze on their net interest margins (from high levels) to hang on to funding.

The US Federal Reserve, inter alia, is providing various liquidity facilities so there are more than enough dollars to go around, just not all in the right places. This feels more like an idiosyncratic mini crisis for now, with SVB and Signature being akin to the BNP money market funds "breaking the buck" and the Credit Suisse solution feeling a bit like a larger Bear Stearns. The crisis would become more systemic in nature, a "Lehman's moment," if we start to see a shortage of dollar funding available. I think it will still need the Federal Reserve to undertake another $1-2trillion of quantitative tightening for this systemic shortage of funding to occur, so another 12 - 30 months at the current QT run rate. One hopes that if signs of the banking system falling short of funding do happen then the Federal Reserve will pre-emptively manage its balance sheet accordingly.

The transmission of the banking sector turmoil into the broader economy has four main channels, the first two are through business and consumer confidence. The latter has remained robust so far, even in surveys conducted after the bank failures. Next we have the quantity of loans available; the ability of banks to lend will have reduced as treasurers and chief financial officers look to increase the amount of liquid assets on their balance sheets to cover the risk of any deposit outflows. Finally, and most importantly, there is the price of loans as well as willingness to lend; these are captured in lending standards data. Lending standards had already been tightening significantly before SVB and Signature failed. The next SLO (senior loan officer) data for April's survey, due out early in May, is likely to show a large further tightening.

This tightening in lending standards, and fall in economic sentiment, can do some of the Federal Reserve's monetary tightening job for it. The FOMC meeting came after the bank failures and it instigated a dovish hike of 25bps to take Fed funds rates to the 4.75% to 5.0% range. The statement comes with the appropriate health warnings about the banking turmoil: "*… Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain*." The most important sentence, in our opinion, was that the FOMC "*…anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time*." There are two significant changes compared to prior meetings, firstly the deliberately non-specific "*additional policy firming"* has replaced the prior *"ongoing increases";* secondly, they have moved from "*will be appropriate*" to "*may be appropriate."*

The Summary of Economic Projections (SEP), produced quarterly, had one hawkish element in that the core PCE forecast for 2023 was revised upwards from a 3.2% - 3.7% range to 3.5% - 3.9%. However, the much anticipated increase in the dot plots did not occur. Fed officials had spent most of January and February guiding the markets to an increase in anticipated terminal rates from 5.1% to 5.6%, but the recent banking sector developments have led the Fed to maintain 5.1% as the median dot peak. In the space of two weeks the tightening of financial conditions created by the US banking mini crisis has, by my estimates, knocked 50bps off the Fed's terminal rates. Most economists are predicting one more 25bps in May; the market has approximately a 50% probability of this hike occurring and is then pricing for rate cuts to begin in the summer.

Overall, the key message is that monetary policy works and the cumulative monetary tightening we have seen brings weaknesses in the system to the fore. Although monetary policy infamously works with "long and variable lags" when things do go wrong (a Hemmingway reference to bankruptcy) events unfold "gradually, then suddenly."

Rates

The Fund started the month with 5.75 years of core duration exposure and we took some profits on the long duration position during the crisis, reaching an intra-month low of 5.0 years before starting to increase the position size towards the end of March. At month end the Fund had a long duration position, with 5.25 years in core markets split between 2.0 years in the US, 1.75 years in the UK, European duration of 1.0 years and 0.5 years in New Zealand. The Fund also has a 0.5-year short in Japan; although this is more of an alpha trade, its purpose has evolved as JGBs (Japanese Government Bonds) have benefitted from some flight to safety too. We've retained this low beta short as good ballast, enabling us to stay long duration in the core.

The biggest change to rates positioning during March was to increase the size of a yield curve steepener; this was manifested by taking net duration exposure in the 15+ year maturity bucket to zero. The lower predicted terminal Fed funds rates and weakening growth outlook have already led to some steepening (or reduced curve inversion) and we expect much more normalisation to follow.

Allocation

Investment grade exposure is a little under 50% and net high yield exposure is 20%. In fortuitous timing ahead of the banking mini-crisis, we had reduced high yield exposure to 17%. Valuations improved during the market turmoil and we lifted some of the credit default swap index overlay (iTraxx Xover) to take the net high yield weighting back to our neutral level of 20%. There is good long-term value in credit, but with the recessionary risk for the second half of 2023 rising there will inevitably be further volatility in credit markets. If credit spreads widen enough to make valuation levels become more compelling again, then we will increase allocations to take exposure back to being overweight.

Selection

In the reduction in the high yield exposure in early March, we sold out of short dated Drax bonds in US dollars which offered little residual upside. Two higher beta holdings were sold too: subordinated debt issued by both Telefonica and AT&T. The companies themselves are great credits but hybrid bonds do exhibit elevated market volatility. Within investment grade, we sold out of Credit Suisse senior debt on the second of March. We were concerned about ongoing deposit outflows but did not expect such a rapid demise to occur. On the purchase side of the ledger, a new issue from Brambles offered a great entry opportunity to buy bonds in a defensive credit and leader in the circular economy (reusable pallets and packaging containers) at an attractive credit spread.

Finally, to answer an understandably oft-asked question during the month, the Fund's AT1 exposure is just under 1%, split between holdings in Barclays and Julius Baer.

Discrete 12 month performance to last quarter end (%):**
Past Performance does not predict future returns

	Mar-23	Mar-22	Mar-21	Mar-20
Liontrust GF Strategic Bond B5 Acc	-3.89	-3.96	13.15	-0.40
EAA Fund Global Flexible Bond - USD Hedged	-3.09	-2.98	13.23	-1.88

*Source Financial Express, as at 31.03.23, total return, B5 share class.
**Source Financial Express, as at 31.03.23, total return, B5 share class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio (13.04.18).

Fund positioning data sources: UBS Delta, Liontrust.
†Adjusted underlying duration is based on the correlation of the instruments as opposed to just the mathematical weighted average of cash flows. High yield companies' bonds exhibit less duration sensitivity as the credit risk has a bigger proportion of the total yield; the lower the credit quality, the less rate-sensitive the bond. Additionally, some subordinated financials also have low duration correlations and the bonds trade on a cash price rather than spread.

Key Features of the Liontrust GF Strategic Bond Fund

Investment objective & policy[1]	The investment objective of the Fund is to maximise total returns over the long term through a combination of income and capital. The Fund will seek to achieve its objective by investing in bond and credit markets worldwide. The Fund invests in a wide range of bonds issued by corporates and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 40% of its net assets invested in emerging markets. Investments may be made in "hard" currencies, such as US Dollar, Euro and Sterling, and up to 25% of the net assets of the Fund may be invested in soft currencies, such as those of emerging markets. Where the Fund invests in non-US Dollar assets, the currency exposure of these investments will generally be hedged back to US Dollar. Up to 10% of the Fund's currency exposure may not be hedged, i.e. the Fund may be exposed to the risks of investing in another currency for up to 10% of its assets. The Fund may invest both directly, and through the use of derivatives. The use of derivatives may generate market leverage (i.e. where the Fund takes market exposure in excess of the value of its assets). In addition, the Fund may invest in cash or cash equivalents, such as deposits and Money Market Instruments, for cash management purposes. Within the limits stated above, there are no geographical or economic sector restrictions on the Fund's investments. The Fund has both Hedged and Unhedged share classes available. The Hedged share classes use forward foreign exchange contracts to protect returns in the base currency of the Fund. The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
Recommended investment horizon	5 years or more
Risk profile (SRRI)[2]	4
Active/passive investment style	Active
Benchmark	The Fund is actively managed without reference to any benchmark meaning that the Investment Adviser has full discretion over the composition of the Fund’s portfolio, subject to the stated investment objectives and policies.
Sustainability profile	The Fund is a financial product subject to Article 8 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: 1. As specified in the KIID of the fund; 2. SRRI = Synthetic Risk and Reward Indicator. Please refer to the KIID for further detail on how this is calculated.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/glossary

Key Risks:

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Investment in the GF Strategic Bond Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. Bond markets may be subject to reduced liquidity. The Fund may invest in emerging markets/soft currencies and in financial derivative instruments, both of which may have the effect of increasing volatility. The use of derivatives may create leverage or gearing. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead.

[23/242]