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Sustainable Investment

Q4 2023 Review

Liontrust Sustainable Future Monthly Income Bond Fund

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The Fund returned 11.4% over the quarter, compared to 7.8% return from the IA Sterling Corporate Bond sector (comparator benchmark) and 9.8% return from the iBoxx Sterling Corporates 5-15 Years Index (target benchmark)*.

Much like the first nine months of the year, the final quarter of 2023 proved to be eventful and volatile. The main development came in the final weeks of the year, however, as the Federal Reserve (Fed) signalled that it was moving to a less hawkish stance, ushering in a sharp rally across financial markets. The speed and severity of these moves surpassed even the large moves seen earlier in the quarter, as markets lurched to pricing multiple rate cuts in 2024 and beyond.

UK government bonds came into the quarter under pressure amid a backdrop of residual strength in economic data globally, albeit predominantly led by the US, and 10yr gilt yields reached a high of around 4.70% in mid-October. A marked rally in November following softer inflation releases in US and European then saw 10yr gilt yields fall some 50 basis points (bps) from their peak.

After such a sharp repricing, markets were given little time to rest, as European inflation surprised significantly to the downside again, while comments by central bankers fuelled a market narrative that the hiking cycle was over, and the focus could now shift to cuts.

Comments from Governor Waller in the US and Isabel Schnabel of the ECB, both notoriously hawkish members of their respective central banks, sparked a rally in the first week of December, before the central bank meetings themselves set in train a sharp repricing lower in yields into the Christmas break.

Having attempted to pushback somewhat on the market moves in the weeks before their meeting, the Fed surprised by changing tack. It moved away from the consistent communication of the need to maintain restrictive policy for longer to return inflation to target.

More interest rate cuts were included in the Fed's dot-plot forecasts, with the median moving from one cut to three in 2024. This move, focusing more on the declines in inflation and ignoring the impacts of rate moves on financial conditions, something Fed chair Jay Powell had been pointing to repeatedly just a couple of weeks prior, solidified the market's belief that the time had come to price in a significant easing in US monetary policy.

Somewhat surprisingly, it was the Bank of England (BoE) and the ECB which maintained the consistent message that rates would have to stay higher for longer in order to tame inflation and stamp out the threat of persistence, despite the economic outlook looking more challenged than in the US. However, following the Fed's surprise comments, markets duly ignored the ECB and BoE protestations.

The UK market was quickly validated in its scepticism, as the weaker readings in both GDP and private sector regular pay growth (a key measure for the BoE) were coupled with a large miss in the November inflation numbers. The miss was also broad-based, with food and energy inflation both moderating as expected, while core goods and services inflation both declined meaningfully too.

Services inflation, being the metric the MPC has focused on most, is now running more than half a percentage point below the BoE's most recent estimate. Being the more domestically-sensitive component of inflation, this trend is encouraging and, should it continue alongside weakening global goods prices, we think inflation will decline faster than the BoE anticipates. Inflation has now materially undershot expectations in two of the last three prints, and while it remains elevated, the consistent global drift lower is somewhat reassuring.

The BoE, Fed and ECB all maintained their respective benchmark rates over the quarter, however the aforementioned dynamics led to sizable declines in yields across all developed markets. 10yr gilt yields ultimately ended the year around 3.60%, over 100bps lower than their October peak. Similar sized moves were seen in the US, while German yields lagged somewhat, perhaps given they were already pricing lower long term yields relative to short term interest rates.

Other assets also performed strongly as markets worked through the implications of a 'soft landing' scenario becoming the consensus view. Sterling corporate bond spreads tightened by 24bps over the quarter, as credit markets were supported by falling yields and the perception that monetary policy easing would help avoid a harsher economic outcome.

Fund performance

The Fund delivered strong performance, driven by the significant move lower in government bond yields over the quarter. The Fund benefited from its long duration interest rate positioning relative to the benchmark, which coupled with positive stock selection within certain sectors, led to strong absolute and relative returns.

Our duration management was the biggest driver of outperformance over the period. We started the quarter being +1.25 years long to the UK with 10yr yields standing at 4.44%, well above our 2.5% to 3.0% fair value target. However, following the pivot signal from the Fed and the subsequent rally, we reduced our overweight position by 0.25 years. Subsequent weak economic data releases pushed gilt yields lower, leading us to reduce our active position by another 0.25 years to end the quarter at +0.75 years relative to the benchmark.

Our credit positioning also contributed positively to performance, driven primarily by stock selection. Even though we saw spread compression in the corporate sterling index, sector allocation was flat over the period. This can be attributed to the Fund's lower spread duration and our allocation to more defensive sectors including gilts and housing associations, which lagged the broad-based risk rally. However, stock selection contributed positively to quarter end performance, where higher beta names within banks and REITs fared well, recovering most of

their previous underperformance. Given the supportive conditions for risk assets, our higher beta, subordinated banks holdings performed strongly, as well as longer spread duration bonds within the sector. Higher levered REIT names had a similar trajectory, as expectations of lower rates supported property valuations and alleviated concerns over upcoming refinancing needs.

Trading activity

Trading activity picked up over the quarter, with corporate bond issuance stronger than expected amid the pronounced rally in rates. Financials issuance, in particular, experienced a significant uptick.

We participated in a newly issued high-coupon bond from Pension Insurance Corp, a leading operator in the Bulk Purchase Annuity market, with predominately investment-grade exposure and a healthy solvency position, which we favour from a business risk view.

Exploiting opportunities arising from increased financials issuance, we also performed relative value switches in issuers such as Barclays and Phoenix, switching existing bonds into new issues.

Outside of financials, diversification was a key driver as we added new holdings of Veralto and Suez to the Fund. Veralto, a spin-out company from Danaher, specialises in providing technology for water testing and treatment, as well as offering traceability and regulatory printing solutions for consumer-packaged goods. The company supports a high-growth profile, making it an appealing addition. Suez, emerging as a new entity post the Veolia acquisition, predominantly encompasses French water and UK waste and recycling operations, moving exposure to water assets outside of the pressured UK regulatory regime.

On a relative value basis within non-financials, we switched from dollar-denominated Deutsche Telekom bonds into a similar maturity sterling issue, capitalising on the outperformance of the former. Additionally, we finished disposing of our position in Mobico perpetual bonds, having largely reduced it in Q3 and used the proceeds to top up favoured names.

On disposals, we sold out of our AXA perpetual paper. The bond had outperformed the market on expectations that it would be taken out in a liability management exercise.

Outlook

Given the recent pivot in market expectations following a change in central bank narrative and softening economic data, it appears we have reached the peak of the interest rate tightening cycle and are now moving towards a rate cutting environment. This is supportive for fixed income valuations, while also increasing the likelihood of a soft economic landing.

At the same time, we are starting to see the impact of higher rates filtering through into the real economy, and expect that this will only accelerate with the majority of the impact still to be felt. Inflation has already shown signs of softening and we expect it to fall further amidst weaker consumer demand due to the ongoing transmission of higher interest rates. The latter will also result in weaker economic growth, ultimately making central banks higher for longer narrative unsustainable.

Therefore we continue to see significant value in government bond yields, and we maintain a long duration position.

While corporate bonds have performed strongly over the final quarter of 2023, we continue to believe that corporate credit is attractive at all-in yields above 5%.

While we see a challenging economic growth outlook, we continue to believe that corporate bonds can perform well against this backdrop. Corporate fundamentals remain robust, with low levels of leverage, high interest coverage and ample liquidity. Though corporate fundamentals will inevitably weaken through a period of economic deterioration, they start from a healthy position above long-run averages, so investment grade companies should be able to

navigate this period. Defaults are not expected to tick up beyond the long-term average, so current levels of return more than adequately compensate for inherent risks and provide an attractive entry point.

In terms of sector positioning, we remain underweight to consumer sectors, with the delayed impact of interest rate hikes still to have their full impact. The Fund remains overweight financials, based on attractive valuations and this is expressed through overweight positioning to both the banks and insurance sectors. We remain overweight to telecoms due to their resilience and growth characteristics and remain underweight to the utilities sector.

Overall, we are constructive on the prospects for corporate bonds, based on attractive valuations and strong fundamentals.

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Discrete years' performance (%) to previous quarter-end:

	Dec-23	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust Sustainable Future Monthly Income Bond B Gr Inc	13.1%	-15.4%	-0.2%	5.5%	9.4%
iBoxx Sterling Corporates 5-15 years	11.3%	-19.2%	-3.3%	8.6%	10.7%
IA Sterling Corporate Bond	9.4%	-16.1%	-1.9%	7.8%	9.5%
Quartile	1	2	1	4	3

*Source: FE Analytics, as at 31.12.23, B share class, total return, net of fees and interest reinvested.

**Source: FE Analytics, as at 31.12.23, primary share class, total return, net of fees and interest reinvested.

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

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

All investments will be expected to conform to our social and environmental criteria.

Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;

The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund.

The Fund can invest in derivatives. Derivatives are used to protect against currency, credit or interest rate moves or for investment purposes. There is a risk that losses could be made on derivative positions or that the counterparties could fail to complete on transactions.

The Fund uses derivative instruments that may result in higher cash levels. Cash may be deposited with several credit counterparties (e.g. international banks) or in short-dated bonds. A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

The Fund may encounter liquidity constraints from time to time. Participation rates on advertised volumes could fall reflecting the less liquid nature of the current market conditions.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The level of targeted income is not guaranteed.

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.

Disclaimer

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