



Liontrust SF Monthly Income Bond Fund: Q3 2023 review

Fund managers: Aitken Ross, Kenny Watson and Jack Willis

The Fund returned 3.1% over the quarter, compared with the 2.1% average return from the IA Sterling Corporate Bond sector (the comparator benchmark) and 2.6% return from the iBoxx Sterling Corporates 5-15 Years Index (the target benchmark)*.

The third quarter posed challenges for global bond markets as conflicting macroeconomic data continues to paint a mixed picture, resulting in significant volatility in government bond yields. However, despite this volatility 10 year Gilt yields were broadly unchanged over the quarter.

In the UK the Bank of England delivered a widely expected 25 basis points (bp) interest rate hike, before surprising markets by electing to leave interest rates unchanged at its September meeting. This came against a backdrop of falling inflation, softening growth, and a loosening in the labour market. However the Bank of England acknowledged that there remains a long way to go to reach the 2% inflation target, emphasising a higher for longer path for interest rates, particularly given ongoing strength in wage growth and demand for services. This has led markets push out expectations for interest rate cuts.

However we continue to believe that inflation will fall faster than the Bank of England and broader market forecast, driven by the continued decline in consumer demand with the full impact of interest rate hikes yet to be felt. This is combined with disinflationary pressures from deflationary producer prices and still significant base effects to fall out of inflation calculations. Services inflation has been a key focus for the BoE, however we expect the recent softness seen in the August figures to continue, with leading indicators such as PMIs suggesting that deterioration in the services sector is starting to catch up with the broader economy. The resulting weakness in both inflation and growth outlooks is likely to challenge the BoEs higher for longer narrative.

In the US, the Federal Reserve similarly raised rates by 25bps at its the first meeting of the quarter before also maintaining interest rates at the second, marking the second pause this year. US 10-year treasury yields climbed 74bps, driven by expectations of an extended period of higher rates, amidst several Fed officials all reiterating the higher for longer narrative. Whilst still correlated with wider government bond yields, the US materially underperformed over the period, as the ongoing resilience of the underlying economy continues to diverge from the weaker outlooks for both Europe and the UK, particularly the strength in the US labour market. US underperformance was further compounded by fiscal concerns, with a growing budget deficit, threat of government shutdown, and Sovereign rating downgrade by Fitch

In Europe, the European Central Bank raised rates twice during the quarter, each time by 25bps, bringing deposit rates to an all-time high of 4%. While the central bank hinted that the most recent hike might be its last, hawkish rhetoric from the US and rising oil prices pushed yields in Europe higher. Although expectations for the first interest rate cut were pushed further into the future, another hike appears unlikely in the context of growing concerns about economic growth stagnating at best across Europe.

During the third quarter, despite high levels of volatility from a yield perspective, sterling corporate bond credit spreads tightened around 15bps over the period as demand for corporate credit remained robust. Credit curves steepened as greater clarity over the near term path of interest rates led shorter dated spreads to perform well, whilst higher uncertainty over the longer term outlook saw a more muted tightening for longer dated bond spreads.

Performance

The Fund outperformed its benchmark in the last quarter, with outperformance having been predominantly driven by the Fund's credit positioning, while long interest rate positioning detracted from performance amidst rising yields.

While UK 10-year yields saw only modest increases due to weaker economic data and subdued inflation prints, 30-year yields sold off in late September, driven by stickier inflation expectations and the narrative of enduring higher rates. This negatively impacted performance, as the Fund is overweight long duration relative to its benchmark and adversely affected by increase in yields.

During the quarter, we retained our overweight position, as 10-year yields remained were elevated, and currently stands at 1.25 years long relative to the benchmark. After the pause in rate hikes from the Bank of England, 2-year gilts rallied and caused a steepening of the UK gilt curve.

We made adjustments to our cross market trade during the quarter, closing our short position on US 10-year yields and retaining our long position on UK 10-year yields, as strong US economic data heightened concerns about a longer period of higher rates. Thus, our current overweight interest rate positioning is expressed solely through the UK.

On the other hand, our overweight credit positioning performed well over the quarter and generated strong outperformance, driven both by stock and security selection. The largest contributors were financials and utilities.

Our overweight position to banks proved to be the strongest contributor, supported by the strong reporting period and increased profits given the prevailing high interest rate environment. We maintain an overweight position on subordinated banks, which has benefitted the fund as they have outperformed higher quality paper. Furthermore, our holdings across high quality European names continue to benefit from improving net interest margins in a higher rate environment, alongside well-capitalised balance sheets and robust asset quality, resulting in credit ratings either remaining stable or improving across the names held. We believe these companies are well positioned to benefit from a high interest rate economy and capture a potential recovery.

Our insurance holdings also fared well over the quarter with positive returns driven by strong stock selection. The sector is also benefiting from current interest rate levels, but also from rigorous balance sheet management and high levels of solvency ratios, hence the decision to maintain our overweight position.

In the utilities space, our underweight position in the sector delivered strong performance. We currently maintain a 10% underweight position relative to the benchmark, which translated into positive performance from sector selection. Utilities faced a setback as the anticipation of prolonged higher interest rates weighed down the valuations of new investment projects, coupled with idiosyncratic challenges faced by UK water companies. However, we believe the utility sector stands to gain from high wholesale margins and investments in renewable energy. This has translated into strong year-to-date earnings, fuelled by favourable energy price trends and asset growth.

Trades

Trading activity was limited over the quarter. We primarily participated in new issues in financials, while activity in other sectors was low. New issues in general picked up, but given strong investor demand, these often resulted in aggressive valuations and hence we would decide not to participate.

We participated in a newly issued short-dated bond from Yorkshire Building Society, a bank with predominately exposure to mortgages, which we favour from a business risk view. The bank is defensively managed with low leverage, strong asset quality and strong liquidity. We also favour from a sustainability standpoint, with 87% of

the loan book relating to owner occupied mortgages but also providing commercial loans to housing associations.

We also focused on performing relative value switches in the financial sector, making switches within Zurich and BNP paper.

Outside of financials, we largely reduced our holding in Mobico's (previously National Express) hybrid notes, following uncertainty over new management and recent issues with contract renewals and US bus drivers' wage negotiations.

Also, we disposed of Canary Wharf Group on grounds of credit quality and concerns over medium term performance. Whilst we believe the name had strong ESG credentials, demand for office space has been deteriorating and pressure on commercial real estate values weighed on the company's ability to manage leverage and covenant metrics.

Outlook

We continue to believe that corporate credit offers significant value at these levels of all-in yields.

Despite market volatility, recent developments re-enforce our belief that we are at or very close to the end of the interest rate tightening cycle. We are starting to see signs of 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 yet to be felt. We expect inflation to continue to fall amidst weaker consumer demand due to ongoing transmission of higher interest rates, which will also result in weaker economic growth, ultimately making central banks higher for longer narrative sustainable.

Therefore we continue to see significant value in government bond yields, with a still significant upside to reach fair value, and maintain our long duration position.

This is coupled with credit spreads that continue to misprice the underlying strength of corporate balance sheets. Whilst we expect growth to be challenged, we expect this to primarily be driven by the consumer. Corporate fundamentals remain very robust, with low levels of leverage, high interest coverage and ample liquidity. Whilst corporate fundamentals will inevitably weaken through a period of economic deterioration, the incredibly strong starting point significantly above long-run averages, means investment grade companies will be able to navigate this period. Defaults are only expected to return to long-run averages, whilst current spread levels imply a far higher deterioration in the default cycle, leading us to believe that corporate spreads remain at an attractive entry point for investors.

Discrete years' performance**, to previous quarter-end:

Past performance does not predict future returns

	Sep-23	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust Sustainable Future Monthly Income Bond B Gr Inc	9.9%	-22.4%	4.7%	3.7%	5.0%
iBoxx Sterling Corporates 5-15 years	9.8%	-25.4%	0.4%	4.5%	10.9%
IA Sterling Corporate Bond	7.3%	-20.5%	1.3%	4.2%	9.0%

*Source: FE Analytics, as at 30.09.23, B share class, total return, net of fees and interest reinvested.

**Source: FE Analytics, as at 30.09.23, 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: 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

This document is issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business.

It should not be construed as advice for investment in any product or security mentioned, an offer to buy or sell units/shares of Funds mentioned, or a solicitation to purchase securities in any company or investment product. Examples of stocks are provided for general information only to demonstrate our investment philosophy. The investment being promoted is for units in a fund, not directly in the underlying assets.

The document contains information and analysis that is believed to be accurate at the time of publication, but is subject to change without notice. Whilst care has been taken in compiling the content of this document, no representation or warranty is given, whether express or implied, by Liontrust as to its accuracy or completeness, including for external sources (which may have been used) which have not been verified.

This is a marketing communication. Before making an investment, you should read the relevant Prospectus and the Key Investor Information Document (KIID) and/or PRIIP/KID, which provide full product details including investment charges and risks. These documents can be obtained, free of charge, from www.liontrust.co.uk or direct from Liontrust. If you are not a professional investor please consult a regulated financial adviser regarding the suitability of such an investment for you and your personal circumstances.