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Sustainable Investment

Q4 2023 Review

Liontrust GF Sustainable Future European Corporate Bond Fund

Aitken Ross
Investment Manager

Kenny Watson
Investment Manager

Jack Willis
Investment Manager

The Fund returned 7.1%*† in euro terms over the quarter, compared with the 5.6% return from the Markit iBoxx Euro Corporates Index comparator 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, 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 push back 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.

Past performance does not predict future

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.

Performance

The Fund strongly outperformed its benchmark over the quarter with outperformance driven by both its long duration and credit positioning.

Interest rate positioning comprised the biggest positive contributor to performance. We started the quarter 0.50 years overweight duration relative to the benchmark, which was expressed solely through the UK. This reflects the underperformance of gilts relative to bunds and treasuries. However, with deteriorating economic data in the euro area and anticipation of a policy turn by the European Central Bank, we increased duration by 0.25 years to benefit from bund yields falling sooner. Year-end overweight interest rate position now stands at 0.75 years, expressed through the UK and the Euro area.

In terms of credit positioning, the fund delivered positive performance from both sector and stock selection, with Banks and REITs being the biggest contributors. 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. REITs also performed well over the quarter, with higher levered REIT names leading the rally, as expectations of lower rates supported property valuations and alleviated concerns over upcoming refinancing needs. Consequently, our overweight positions within those sectors coupled with stock selection added

positively to performance. Outside of financials, our overweight to telecommunications and stock selection within it contributed to strong credit performance.

Trading activity

Trading activity was relatively limited over the quarter. We primarily participated in relative value trades in the financials sector, while activity in other sectors was low. Switches were made between paper in Santander and Barclays. We also disposed of Axa perpetual bonds which had performed well, and reinvested the proceeds into favoured bonds in Phoenix and Aviva.

Outside of financials, we also participated in a new green deal from Telefonica, a defensive leader in its markets with decreasing leverage and comfortable liquidity. We funded this by selling down positions in Verizon and Compass Group.

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, whilst 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 well 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 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.

Key Features of the Liontrust GF SF European Corporate Bond Fund

INVESTMENT OBJECTIVE & POLICY[1]:	The Fund aims to maximise total returns (a combination of income and capital growth) over the long term (five years or more) through investment in sustainable securities, primarily consisting of European investment grade fixed income securities. The Fund invests at least 80% of its assets in bonds issued by companies which are denominated in Euro or non-Euro corporate bonds that are hedged back into Euros. The focus is on investment grade corporate bonds (i.e. those which meet a specified level of creditworthiness). The Fund invests in companies that provide or produce more sustainable products and services as well as having a more progressive approach to the management of environmental, social and governance (ESG) issues. Although the focus is on investment grade corporate bonds, the Fund may also invest in government bonds, high yield bonds, cash or assets that can be turned into cash quickly. Where the Fund invests in non-Euro assets, the currency exposure of these investments will generally be hedged back to Euro. 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). 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.
RECOMMENDED INVESTMENT HORIZON:	5 years or more
SRI[2]:	4
ACTIVE / PASSIVE INVESTMENT STYLE:	Active

BENCHMARK:	The Fund is considered to be actively managed in reference to IBOXX Euro Corporate All Maturities (the "Benchmark") by virtue of the fact that it uses the benchmark(s) for performance comparison purposes. The benchmark(s) are not used to define the portfolio composition of the Fund and the Fund may be wholly invested in securities which are not constituents of the benchmark.
SUSTAINABILITY PROFILE	The Fund is a financial product subject to Article 9 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: [1]As specified in the PRIIP KID of the fund; [2]SRI = Summary Risk Indicator. Please refer to the PRIIP KID for further detail on how this is calculated.

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

	Dec-23	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust GF Sustainable Future European Corporate Bond A5 Acc EUR	10.4%	-14.8%	-0.3%	1.0%	7.3%
Markit iBoxx Euro Corporates Index	8.2%	-14.2%	-1.1%	2.7%	6.3%

*Source: FE Analytics, as at 31.12.23, A5 share class, in euros, total return (net of fees and income reinvested). Discrete data is not available for 10 full 12-month periods due to the launch date of the portfolio.

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 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.

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