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Liontrust SF Corporate Bond Fund: Q3 2022 review

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The Fund returned -12.3%*† over the quarter, compared with the -11.5% return from the iBoxx Sterling Corporate All Maturities Index comparator benchmark and the average return from IA Sterling Corporate Bond sector, also a comparator benchmark, of -9.2%.

Market backdrop

Financial markets came under significant pressure over the third quarter, despite an initially strong start. The combination of persistent inflation pressures and tightening monetary policy against a weakening economic growth outlook continued to fuel fears over the threat of recession.

The strong start to the quarter was driven by expectations for a dovish pivot by central banks following July's US CPI figure which came in below expectations, heightening optimism that inflation had peaked.

However, this momentum was short lived as central bankers responded forcefully, making it clear that their priority remains firmly on returning inflation to target levels through restrictive monetary policy. This view was re-enforced by inflation data coming in ahead of expectations over the remainder of the quarter.

As a result, 2022 continues to be one of the most challenging years since records began for bonds globally, with the world government bond index falling -21.3% year to date.

The US Federal Reserve ultimately delivered back-to-back 75bps rate hikes over the quarter, which, combined with the resolute hawkish commentary by Fed members, led to a rise in terminal rate expectations, driving treasury yields higher.

Meanwhile, the Bank of England also delivered consecutive 50bps interest rate hikes over the quarter. This likewise saw gilt yields move sharply higher, a move which accelerated aggressively in September following the announcement of the Government's mini-budget. The new Chancellor announced a considerable, larger than expected, unfunded fiscal package. The implication of a significant increase in government borrowing put further pressure on Gilt yields. The pound reached a new record low, falling 8.3% versus the US dollar over the quarter, amidst investor concern with the current government's credibility.

The size and the scale of the yield moves in the gilt market resulted in a collateral crisis in the UK pension fund market, particularly amongst liability driven investment funds. To avert further forced selling, the Bank of England intervened, pausing their quantitative tightening programme and buying long-dated gilts.

In Europe, the European Central Bank also began its rate hiking cycle during the quarter, with consecutive hikes totalling 1.25% during the period, in order to combat rising inflation which continues to be dominated by energy prices given its dependence on Russian energy.

This monetary tightening came in spite of a backdrop of further deterioration in economic data in the US, UK and Europe. Consumer confidence is at, or near, all-time lows; PMIs remain firmly in negative territory (in the UK and Europe); and a negative US Q2 GDP growth figure confirmed a technical recession.

Fund review

The Fund's underweight duration positioning was a source of positive attribution through the quarter as gilts sold-off sharply, although this was offset by a negative contribution from yield positioning. The Fund began the quarter 0.25 years underweight duration versus the index, solely expressed through the UK.

Given the sharp rise in gilts at the end of the quarter, we took the decision to neutralise the duration of the Fund, bringing it into line with the iBoxx Corporate All Stock Index. This neutral positioning includes a 1 year long duration position in the UK 3 year gilt offset by a 1 year short position in the 10 year. Gilt yields are currently at very attractive levels, particularly at the short end of the curve, where we think the Bank of England (BoE) will under-deliver on rate hikes compared against level of tightening already priced into markets.

We engaged in some tactical positioning during the quarter, whereby we increased/reduced our underweight duration position when interest rates span above or below our 2.5-3% target and managed to take advantage of the interest rate volatility in the market.

We also closed our 3s30s steepener for a profit of 40bps. We saw this as a very attractive entry point in the short end of the curve and entered into a 3 year interest rate swap to receive a fixed rate of 5.67%.

Fund trading activity in specific credits remained muted, with new corporate new issuances being sporadic due to volatile conditions, but also due to the relatively quiet period of the year. Despite this, we were able to add a couple of names at attractive new issue premiums and achieve a few relative value switches within specific names.

We added a new high coupon issue from Zurich Insurance Group, which came at a very attractive yield for a highly rated issuer. Zurich is a favoured name in our Fund, as the company has a strong competitive advantage from both a sustainability and a credit perspective. Solvency ratios are at record high levels, meaning the company is well capitalised to weather any financial headwinds and we expect it to be profitable in a high yield environment.

We also participated in a sustainability-linked new issue from Compass Group, a company that provides catering and support services, which we think has superior growth and margin progression. The issue also came at an attractive valuation and a high coupon. We funded the position by trimming small increments from our existing holdings in the real estate and leisure sectors, both of which had performed relatively well from a total return perspective year to date.

We gradually reduced our position in Haleon, the consumer healthcare business. Some negative commentary around the litigation of one of its OTC drugs led the bond's spread to widen slightly; even though we were comfortable with the company fundamentals, we trimmed our holding to reduce further volatility and uncertainty with the name.

Regarding relative value trades, we switched out of Annington paper of different maturities to consolidate a position in its new issue, as we aimed to lengthen our spread duration and at the same time picked up some spread in the process.

We also made a relative value switch within the housing association sector, from Southern Housing into Optivo, with the latter being a higher quality company and offering a better spread on a risk-adjusted basis in our view

Overall, sector allocation versus the index was positive, although housing associations detracted as technical factors – mainly, the imminent end to the BoE's bond repurchasing programme – weighed on the sector. With close links to government policy and funding, it also suffered from the negative reaction to the mini-budget announcement. However, we remain positive on our sector holdings from a fundamental perspective and are confident that they will retrace their relative underperformance in the medium to long term.

We experienced slightly negative security selection, particularly from the insurance, telecommunications and banking sectors. We hold higher beta names in these sectors, which are more exposed to the credit spread widening we've seen recently.

As with last quarter, the financials sector suffered from technical weakness and poor sentiment whilst the market remains in risk-off mode. However, we have conviction in our high-quality names, which should be relatively well positioned for current conditions owing to strong fundamentals and robust operating performance. Financials remain well capitalised with record high solvency rates and we believe their profitability should remain robust in a rising yield environment.

Outlook

The outlook remains challenging, with central bankers facing the difficult trade-off between raising interest rates to combat persistently high inflation and the impact this has on a deteriorating economic growth outlook. This more challenging economic outlook will undoubtedly impact corporate profitability.

However, we believe that investment grade credit is supported by strong fundamentals, with both gross and net leverage at record low levels and debt maturity profiles having been termed out. Interest coverage is still at historical highs, which places companies in a position to weather margin compression. Underlying earnings have grown and remain robust, with cash-to-debt ratios very high.

We believe the market is pricing in too many interest rate hikes, given rates are ineffective at reducing supply-side inflation. Retail sale volumes are already contracting and the slow pass-through of rate hikes (due to fixed rates and term funding) will likely result in a greater economic slowdown if the BoE hikes as much as the market expects.

In our view, a combination of attractive spread levels, high government bond yields and strong corporate fundamentals supports credit from a total return perspective over the medium to longer term. Government bonds have fallen sharply in 2022, giving up most of their gains over the last decade. At the same time, investment grade credit spreads are close to 25yr highs, excluding market shocks. In combination, this has resulted in all-in corporate bond yields moving to levels last seen in early 2000.

In terms of interest rate positioning, we are targeting active duration management rather than a large structural short, hence we have closed the duration short, moving to a neutral position with the flexibility to move long or short in future.

**Discrete years' performance*, to previous quarter-end:
Past performance does not predict future returns**

| | Sep-22 | Sep-21 | Sep-20 | Sep-19 | Sep-18 |
|---|--------|--------|--------|--------|--------|
| Liontrust Sustainable Future Corporate Bond 2 Inc | -26.1% | 2.4% | 4.0% | 8.7% | 0.4% |
| iBoxx Sterling Corporate All Maturities | -23.6% | 0.3% | 4.3% | 11.0% | 0.0% |
| IA Sterling Corporate Bond | -20.5% | 1.3% | 4.2% | 9.0% | 0.1% |

*Source: FE Analytics, as at 30.09.22, primary share class, total return, net of fees and interest reinvested.

Key Risks and Disclaimer

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