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Liontrust SF Monthly Income Bond Fund: Q1 2023 review

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The Fund returned 3.5% over the quarter, compared with the 2.3% average return from the IA Sterling Corporate Bond sector (the comparator benchmark) and 2.9% return from the iBoxx Sterling Corporates 5-15 Years Index (the target benchmark)*†.

Market backdrop

Financial markets generally had a strong start to the year, as stronger than anticipated economic data and falling headline inflation heightened optimism of a soft landing and that central banks are approaching the end of the monetary policy tightening.

This optimism was further supported by the reopening of the Chinese economy, with the potential easing of supply chain pressures supporting lower inflation and stronger growth more broadly.

However, as we progressed through the period, core inflation continued to surprise to the upside, alongside more resilient economic data, raising the prospect of a prolonged period of higher interest rates.

In March, renewed inflation concerns were eclipsed by the significant volatility following the collapse of Silicon Valley Bank (SVB) in the US, which was swiftly followed by Credit Suisse’s plight in Europe. SVB’s demise marked the second largest bank failure in US history, after suffering large deposit outflows following a failed equity raise to bolster its capital position due to losses on its long-dated Treasuries investments.

This sparked fears about contagion risks for the broader banking sector resulting in large deposit outflows from US regional banks and the re-introduction of emergency funding programmes by the Federal Reserve.

These fears were further amplified by the downfall of Credit Suisse, which saw similarly large deposit outflows amidst waning confidence in the bank after it revealed regulator concerns regarding accounting irregularities after already being under heightened scrutiny. Ultimately, this led to government intervention in order to save the bank, with a last-ditch sale to UBS agreed which included significant guarantees and backing by the Swiss government.

Most notably for bond investors, the rescue deal resulted in the full write-down of the bank’s AT1 securities, despite ranking senior to equity investors who received some compensation, undermining the conventional bank loss absorption capital structure.

This understandably undermined confidence in the AT1 asset class, and subordinated bank debt more broadly, with bond investors concerned that in the event of resolution they may rank junior to equity holders.

Investor concerns over the resilience of the global banking system saw a flight to safety, causing a significant rally in government bonds and resulting in strong returns from duration assets including corporate bonds and growth stocks.

Volatility and banking sentiment recovered towards the end of the quarter, as all major central banks came out to reiterate their confidence in the financial system with the risks largely seen as contained, which reassured investors.

Fund review

Trading activity was high during the quarter. We topped up favoured names across financials, telecoms, insurance and utilities sectors and a few names in real estate.

Our sector allocation remains similar, with a slight increase in the banking, utilities and consumers sectors, and a decrease in insurance.

In terms of disposals, we exited positions in Medical Properties and Aroundtown. Regarding Aroundtown, we lost confidence in the management strategy as they seemed to favour shareholders over bondholders in their investment decisions. We exited the position on increasing concerns of further potential downside risk. Poor market sentiment and negative headlines around the tenant performance in Medical Properties' portfolio led us to dispose of our holding.

We rotated into new issues, especially in the banking sector where issuance has been high. We participated in a new issue from Prologis, a highly rated property company with a focus on the logistics industry that offered an attractive new issue premium. We also participated in new issues from Lloyds, BNP and ING in the banking sector, which came at attractive valuations.

We implemented several relative value switches over the quarter. We reduced spread duration within our insurance holdings, switching out of longer dated L&G and Axa paper into shorter dated bonds from L&G, as curves flattened with the long end outperforming. We also repatriated some US dollar denominated telecom names, namely Vodafone and Deutsche Telekom, into sterling equivalents, due to recent outperformance of dollar denominated credit.

We were active in terms of our duration positioning over the quarter. Keeping in mind our fair value yield target of 2.5% - 3.0% for UK 10 year government bonds, we started the year 1 year long duration versus the benchmark when yields were standing at 3.67%.

In the aftermath of both the Federal Reserve and Bank of England stepping down to 25bps hikes, yields fell towards our target, and we reduced our duration positioning to 0.5 year long.

Yields moved higher in February when stronger than expected GDP data, supportive consumer confidence and PMIs meant that UK was in a stronger economic position than expected and avoided a technical recession. As a result, we increased our long position to 0.75 years.

However, with the collapse of Silicon Valley Bank and Credit Suisse in March, we saw significant volatility and heightened concerns over the financial system, which caused a rally in government bond yields. We therefore reduced our long duration positioning to 0.5 years.

Our tactical duration positioning contributed 100bps to performance over the quarter.

We were also active in terms of curve positioning. We entered into a US 2s10s curve steepener in February, as the inversion was standing at 88bps, levels that were last seen in 1980s. We closed that positioning profitably in the aftermath of the SVB concerns in the US after US 2 year treasuries yields rallied 100bps. Our curve positioning contributed 5bps of positive performance.

With regards to credit performance, banks and insurance rallied in January and February, but their outperformance was unwound amid flight to safety following the collapse of SVB and Credit Suisse.

Investors in Europe became overly concerned after the write down of the AT1 securities in Credit Suisse which affected subordinated financials in Europe. Even though we had no exposure to Credit Suisse or US regional banks, our overweight positioning on subordinated financials had a negative impact on performance.

However, as volatility and concerns subsided, we have seen most of the sector recover from its spread wides. It is important to note that UK and European banks are not exposed to SVB and Credit Suisse issues, due to several factors. These have better regulation, a more retail focused business model, stronger liquidity and capital ratios as well as BoE and ECB monitoring. Credit ratings continue to be stable/improving in our holdings.

REITs share similar narrative to banks, rallying in January and February until the negative effect of the banking turmoil spurred concerns over unaffordable bank financing. However, the impact of this is now considered to be less severe than initially thought and mostly limited to US commercial real estate. We do not have exposure to that sector and we continue to see value in the names we hold, which offer attractive yields with supportive fundamentals.

Sectors that have performed well during this period comprise travel and telecoms as their ability to pass on costs to consumers in a market with persistent inflation translated into strong operating performance.

Outlook

The challenge facing global central banks remains, to return inflation to target whilst limiting the impact on their respective economies. The full effect of the significant monetary policy tightening on the economy is still to be felt and a tightening in bank lending standards will surely follow from SVBs collapse, which will add to the economic headwinds.

Given this, we believe that the market is pricing in too many rate hikes and expect that we are close to the peak in interest rates. Economic data has been more resilient than forecast than at the start of the year, and whilst we do expect a recession, we believe that this will be shallower than the market is pricing in. Against this backdrop we are long interest risk, expressed via a 0.75 years long duration position in the UK, as we believe that government bonds offer attractive value.

In terms of credit positioning, we remain of the view that credit offers attractive value, with credit spreads trading well above their long-term average.

A shallower recession is supportive for credit markets coupled with a strong starting position from a fundamental perspective. Balance sheet strength in terms of leverage and liquidity remains strong, as do other metrics such as interest cover. This reflects well termed out debt maturity profiles and companies previously locking in financing at low all in funding costs.

From a technical perspective, the Bank of England corporate bond disposal programme – which had been viewed as a potential negative overhang – continues to progress smoothly as investor appetite remains strong for credit. This is also evident in the new issue market.

So, whilst we do expect economic headwinds to increase going forward, we believe that corporate bonds are well positioned to face this.

From a valuation perspective our fund has a gross redemption yield of 6.12%, which we believe offers compelling value for a portfolio of high-quality corporate bonds.

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

	Mar-23	Mar-22	Mar-21	Mar-20	Mar-19
Liontrust Sustainable Future Monthly Income Bond B Gr Inc	-8.5%	-4.0%	14.9%	-3.0%	1.1%
iBoxx Sterling Corporates 5-15 years	-11.2%	-5.6%	10.6%	-0.3%	4.5%
IA Sterling Corporate Bond	-9.1%	-4.2%	9.0%	0.8%	3.0%

*Source: FE Analytics, as at 31.03.23, B 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 and Disclaimer

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