Simon Bond
Fund Manager
(Since December 2013)

AUM

£191 million*

*as at 31 Mar 2020.

Threadneedle UK Social Bond Fund

Background

The Fund's remit is to provide the return that should be expected for the risk taken and to add value through optimising the social benefits of the investments, while providing for daily liquidity. The Fund aims to deliver 80% of its outcomes from UK domestic projects and so there is naturally a higher proportion of UK issuers than the index to deliver this impact.

Sterling investment grade (IG) credit had a poor first quarter, as a fall in underlying gilt yields was more than offset by widening credit spreads. The Fund's benchmark 1-10 Year Non-Gilt index fell -2.72% over the quarter, with returns for March alone down -3.99%. The negative return came despite a strong start to the year. After the gradual tightening in spreads seen in December, the market continued in this trend through January and much of February. From there, however, spreads began to widen again as concerns grew about the economic impact of Covid-19.

The pressure on credit and other risk assets intensified in March, as the outbreak approached pandemic status and governments took draconian steps to contain it. With much of the world under lockdown, markets increasingly priced in a sharp recession in most developed markets. Meanwhile, a collapse in oil prices was exacerbated by the dispute between Russia and Saudi Arabia over production levels and pricing. Against this, a coordinated policy response from governments and central banks was impressive in its speed, scope and scale. Together with increasingly attractive valuations, this did provide some support for risk assets. Credit markets in particular benefited from news that the US Federal Reserve was to include corporate bonds in a new unlimited asset-purchase programme.

In the UK, the Bank of England cut rates to a record low, offered banks special terms for loans to small businesses, and said it would buy £200 billion in bonds, including corporate debt. A complementary fiscal package from the government included grants and business-rates holidays for hard-hit sectors, and income-replacement schemes for both employees and the self-employed unable to work. Sterling IG fared better in spread terms than its US and European counterparts, as the market recouped its Brexit-related underperformance of 2019.

Activity

During the period we moved duration to longer than the index as a defensive measure, but also to benefit from further QE measures. The position against the curve was to benefit from a flattening of the yield curve and demand for longer-dated credit. Cash was increased as a defensive measure against the heightened illiquidity of credit markets and in expectation of further attractive new issues.

The main volatility within the portfolio came from the Retail Charity Bonds, which represent around 3% exposure. These suffered from significant price falls and subsequent recovery, despite which they were a major drag on performance. We believe that these bonds were priced at unfairly low levels and as we attempted to add to positions it became clear that illiquidity, rather than trading activity, were the cause as bonds were not available at the lower-price levels.

Activity (continued)

We also added to other positions that we found attractive at wider spread levels with somewhat more success, but the best opportunity to source new bonds came from the new issue market at the end of the period. These opportunities allowed us to add both yield and social intensity to the portfolio.

The market has been quick to respond to the current health crisis through the issuance of bonds whose proceeds specifically target responses to the Covid-19 outbreak. We used the market volatility to add to existing positions and bought a number of new issues in March as opportunities presented themselves, many of which were targeted Covid-19 response outcomes. The new bonds were a social bond focused on combatting Covid-19 from the IFC. The World Bank Group (of which IFC is a constituent) will help developing countries strengthen health systems, including better access to health services to safeguard people from the epidemic, strengthen disease surveillance, bolster public health interventions, and work with the private sector to reduce the impact on economies.

Other new issues included a Covid-19 focused social bond from the African Development Bank, which was a $1 billion issue, almost doubling its social bond issuance. While the outcomes from these bonds are global, they are in keeping with our preference for limiting international exposure (maximum of 20% in the Fund) to those bonds with the highest social impact. In the UK, we participated in an innovative transition bond from Cadent Gas, which will finance the upgrade of infrastructure, reducing methane leakage and enabling transition to greener fuels. This is the kind of bond we would expect to see more of in the future.

The Fund's social outcomes are analysed to levels of social intensity using our proprietary approach and over the period the Fund's composition was enhanced, particularly through opportunities in March. While medium social intensity bonds were maintained at 43%, low social intensity bonds decreased to 14% from 15%, while high social intensity bonds increased from 37% to 38%. Exposure to the eight areas of social outcomes was shifted lightly over the period. Utilities & the Environment remains the largest outcome area in the Fund but is now followed by Transport and Communications Infrastructure.

Overall, the Fund's beta fell slightly over the period and even though we attempted to add to the beta in the latter part of March, this proved difficult in the face of tightening spreads for the bonds we held relative to weaker credits in the index as a whole. We do, however, maintain overall beta above the level of the index to reflect the attractiveness of credit. This exposure is concentrated in more defensive areas including Utilities, Housing Associations and Telecoms with an underweight in the bank sector, which we are minded to reduce as other opportunities present themselves.

Outlook

Sterling IG fared better in spread terms than its US and European counterparts, as the market recouped its Brexit-related underperformance of 2019. Valuations in the market have improved dramatically. Sterling IG spreads finished the quarter around 1.4 standard deviations wide of the long-run (20-year) average compared with around -0.4 at the end of 2019.

Meanwhile, the policy measures described above will help to mitigate the significant – though temporary – interruption to economic output and employment. More specifically, much of the policy response is targeted at keeping the credit channel open. Policymakers want to prevent an economic shock turning into a financial crisis. The Bank of England's decision to start buying IG corporate bonds directly, for example, is designed with credit spreads in mind and augments similar action in the US and Europe. Credit rating agencies have also been quick to act, and the likelihood of further downgrades will hang over the market for the next few months. We note, however, that authorities have asked banks and some corporate issuers to cease the payments of dividends and share buybacks. In isolation, this is credit positive.

In summary, as the second quarter begins, we feel that IG spreads are compensating investors well for the increased credit risk associated with the current crisis.

Note: the source for all data and information is Bloomberg, as at 31 March 2020, unless otherwise stated.

Figure 1: Fund statistics

	Portfolio	Social universe	1-10 Year Universe[1]
Average duration (years)	4.51	7.68	4.33
Average yield	2.51%	2.52%	2.36%
Average rating	A	A	A+
DTS beta	0.73	1.00	0.59

1 ICE BofA Merrill Lynch 1-10 Year Sterling Non-Gilt Index.
Source: Columbia Threadneedle Investments as at 31 March 2020.

Figure 2: Investment by social field

Social field %	Mar 2020	Dec 2019	Change
Cash	4.3	3.0	+1.3
Community services	3.8	6.8	-3.0
Education learning and skills	2.5	2.3	+0.2
Employment and training	6.5	5.9	+0.6
Financial inclusion	10.1	11.5	-1.4
Health and social care	9.5	7.8	+1.7
Housing and property	15.7	15.4	+0.3
Transport and communication infrastructure	19.2	17.5	+1.7
Utilities and the environment	28.4	29.2	-0.8

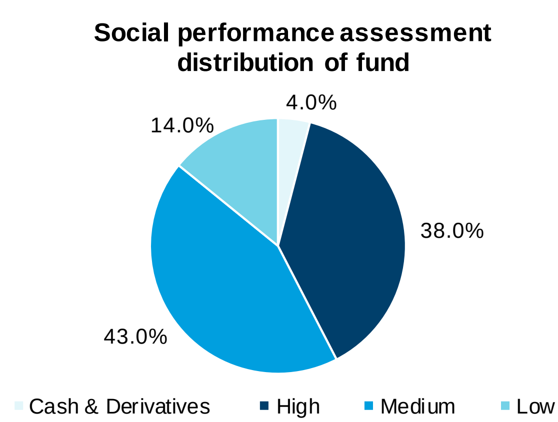
Source: Columbia Threadneedle Investments as at 31 March 2020.

Figure 3: Top 10 holdings

Issuers	Weighting
Motability Operations	3.1%
Transport for London	3.1%
LCR Finance	3.1%
Retail Charity Bonds	3.0%
Dwr Cymru (Financing)	2.8%
Nationwide Building Society	2.8%
Bupa Finance	2.8%
Lloyds Bank	2.7%
Anglian Water	2.6%
HSBC Holdings	2.4%

Source: Columbia Threadneedle Investments as at 31 March 2020. The mention of any specific shares should not be taken as a recommendation to deal.

Figure 4: Social performance assessment



Source: Columbia Threadneedle Investments as at 31 March 2020.

Key risks

Past performance is not a guide to future returns and the fund may not achieve its investment objective. Your capital is at risk. The value of the fund may fluctuate in response to the performance of individual securities and general market conditions and investors may not get back the sum originally invested. When investing in fixed income securities, the fund's value can be impacted by changes in interest rates as well as the impact of inflation on the value of capital and income over time. The fund may invest in derivatives to reduce risk or minimise the cost of transactions. This may benefit or negatively affect the performance of the fund. The fund invests in securities whose value would be significantly affected if the issuer either refused to pay or was unable to pay or perceived to be unable to pay. The fund can hold assets that may prove difficult to sell, which may result in the fund having to accept a lower selling price, sell other investments or forego more appealing investment opportunities. The fund's assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold. Most bond and cash funds offer limited capital growth potential and an income that is not linked to inflation. Inflation is likely to affect the value of capital and income over time. Please read the Key Investor Information Document and the Fund Prospectus if considering investing.

To find out more visit **columbiathreadneedle.co.uk**

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