Fund commentary
Covering Q4 2019
Information for Investment Professionals

UK SOCIAL BOND FUND

Simon Bond
Fund Manager
(Since December 2013)

AUM

£185 million*

*as at 31 Dec 2019.

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 to UK domestic projects and so there is naturally a higher proportion of UK issuers than the index to deliver this impact. Until the UK election in December there had generally been a performance drag from UK issuers relative to their overseas counterparts. With less post-election uncertainty and more clarity regarding Brexit this trend was reversed somewhat towards year end. While uncertainties remain the market had a more risk on feel to the year end with UK gilt yields rising as a consequence.

Overall this pattern of positive credit performance contrasting with negative gilt returns resulted in offsetting influences. Returns, therefore, in the fourth quarter were lower than the three preceding quarters. Credit spreads in the investment grade 1-10 year market tightened by 14bps over the quarter and 40bps for the year as a whole.

Activity
During the period duration was extended longer than the index especially in the period of uncertainty during the run up to the UK election. Cash was increased a little into the year end both as a result of lower liquidity and in anticipation of an uptick in new issue activity in 2020. However, beta was maintained at a level higher than that of the index to reflect a positive view on credit. This higher beta position was beneficial in a period of credit spread tightening, helping to offset the effect of higher gilt yields.

While new issues with positive social outcomes were less prevalent in the sterling market, the fund nevertheless was able to access the primary market through several new bonds. These included a very welcome new issue from RBS in the form of a social bond with a strong focus on deprivation and on lending to small and medium size entities. However, we are less clear about the additionality provided through the lending and have been engaging with the issuer since the issue was announced and also more recently about how they can improve the social intensity of the bond. This did, however, provide an opportunity to diversify exposure, as well as add to the banking sector.

Another new issue came from IADB, which launched a sterling-denominated sustainability bond. While the outcomes are non-UK in focus, the impact is significant, given the high levels of deprivation within Latin America and the Caribbean. In a similar location to IADB, there was also a euro-denominated Green bond issue from Corporacion Andina de Fomento. Both of these are in keeping with similar high impact bonds in the fund with an international focus.

Activity (continued)

Other new issues we bought came from Hutchison Group, an international pioneer of mobile broadband services, and Sovereign Housing Group, one of the largest housing associations in the UK, which manages over 55,000 social homes. In utility providers, we added to existing exposures through the new issues of both Yorkshire Water and Orsted.

In aggregate we added to financials in the form of both banks (including mutuals) and insurance companies, telecoms and housing associations while reducing exposure to the more defensive utilities sector, which had come under pressure ahead of the UK election. In ratings terms this led to an increase in AA-rated bonds and to high yield exposure mainly through additional exposure to Nationwide Tier 1 bonds.

The fund's social outcomes are analysed to levels of social intensity using our proprietary approach and over the period the fund's composition changed slightly. Medium social intensity fell to 43% from 45%, low social intensity to 15% from 16%, while high social intensity remained at 37%. Exposure to the eight areas of social outcomes was shifted over the period in favour of utilities & the environment and housing & property.

We map each of the bonds in the portfolio to the 17 UN Sustainable Development Goals using the 169 targets as a guide. Currently, the leading SDGs financed by the fund are: *SDG 8: Decent Work and Economic Growth (19.7%); SDG 9: Industry, Innovation and Infrastructure (17.45); SDG 11: Sustainable Cities and Communities (13.9%); and SDG 7: Affordable and Clean Energy (10.8%).*

Outlook

In terms of credit, investment grade spreads are below long-term averages. Corporate earnings have been reasonably strong recently but are not leading to improved credit metrics.

Overall, the low-growth, low-inflation backdrop, which allows central banks to keep policy accommodative, creates a supportive environment for investment grade corporate bonds. The fund retains its positions in defensive sectors such as regulated utilities and infrastructure, as they should be more resilient given the late stage of the credit cycle and the level of credit spreads.

In addition, the prevalence of bonds from issuers not funded by common equity mitigates against the risk of returning value to shareholders at the expense of bondholders. Thus, the fund's emphasis on optimising social returns gives it a defensive nature that should mitigate against sentiment turning and allows us to be a little more aggressive in positioning the fund's beta ahead of that of the benchmark.

Figure 1: Fund statistics

	Portfolio	Social universe	1-10 Year Universe[1]
Average duration (years)	4.47	7.92	4.43
Average yield	1.78%	1.94%	1.64%
Average rating	A	A	A+
DTS beta	0.63	1.00	0.52

1 ICE BofA Merrill Lynch 1-10 Year Sterling Non-Gilt Index.
Source: Columbia Threadneedle Investments as at 31 December 2019.

Figure 2: Investment by social field

Social field %	Dec 2019	Sep 2019	Change
Cash	3.0	1.8	+1.2
Community services	6.8	6.3	+0.5
Education learning and skills	2.3	2.4	-0.1
Employment and training	5.9	6.4	-0.5
Financial inclusion	11.5	11.4	+0.1
Health and social care	7.8	7.8	-
Housing and property	15.4	15.3	+0.1
Transport and communication infrastructure	17.5	17.9	-0.4
Utilities and the environment	29.2	30.5	-1.3

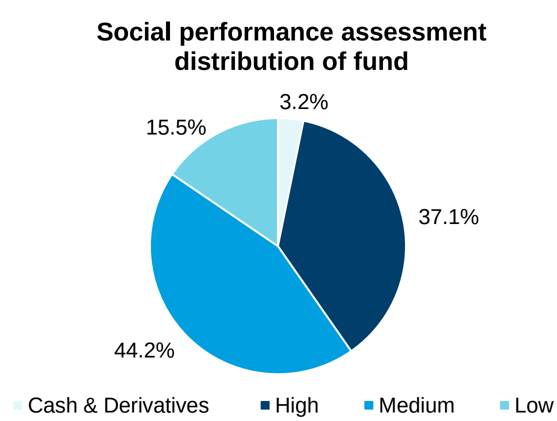
Source: Columbia Threadneedle Investments as at 31 December 2019.

Figure 3: Top 10 holdings

Issuers	Weighting
Retail Charity Bonds	3.5%
Motability Operations	3.4%
LCR Finance	3.1%
Bupa Finance	3.0%
Dwr Cymru (Financing)	2.9%
Transport for London	2.9%
Nationwide Building Society	2.9%
Anglian Water	2.6%
HSBC Holdings	2.3%
Lloyds Bank	2.3%

Source: Columbia Threadneedle Investments as at 31 December 2019. 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 December 2019.

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.

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