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Legal & General
INVESTMENT MANAGEMENT

PMC Fund Commentaries

Q3 2022

This document is intended for Investors and Investment Professionals

Contents

Active Fixed Income

Absolute Return Bond Fund

Over the quarter, the L&G Absolute Return Bond Fund (Z share class Acc.) delivered a performance of 1.09%, versus the comparator benchmark ICE BofA SONIA 3-Month Constant Maturity Total Return Index's return of 0.15%, an outperformance of 0.94%. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Our active rates strategies contributed to performance as we took advantage of large moves in the Rates market. Firstly, we increased duration in July, as we believe that Central Banks would start worrying about recession more than inflation. We took profit as this view materialised, and rates briefly rallied. Then. we re-instated a short position in August as we believe the focus would return to inflation, and we held that position until the end of the quarter. This was very beneficial to the portfolio as government bond yields rose sharply.

Key negative contributors:

On the other hand, our diversified exposure to corporate bonds detracted from performance as those continued to sell off amidst the turmoil in rates markets which led to some widening in credit spreads.

Our active credit strategies also detracted from performance. Exposures to Cocos continued to come under pressure as the ECB continued to tighten monetary policy to curb inflation, while Real Estate Hybrid corporate bonds outperformed.

Positioning:

Over the quarter, we have maintained a credit exposure between defensive and neutral. By the end of the quarter, we have reduced credit risk in the fund, predominantly in the Pan-European space, we have mitigated the impact of our exposure by moving up in quality, particularly in the Coco space where we have swapped long call, lower quality banks for short call, higher quality banks.

We continue to hold a large cash buffer which we are looking to deploy to purchase high quality credit bonds which have severely repriced so far this year

We have been active in our management of duration as we described in the Performance section of this document. As we approached the end of the quarter, we simplified our book of Rates & Inflation positions, but we have started building a long exposure to 10-Year gilts as we believe that recession expectations will be brought forward given market concerns on concerns over the UK government's fiscal policy.

Outlook:

Looking ahead, the most important market driver remains central bank policy. But with the US economy appearing robust and inflation remaining elevated, dovish policy relief appears some time away. In the meantime, rising bond yields and a strong US dollar will keep pressure on leveraged entities. Geopolitically, while much of the focus remains on Ukraine and European energy security, the upcoming China Party Congress could be important for the country's COVID policy as well as more stimulus to offset the property sector's weakness. In sum, while valuations continue to cheapen, the macro backdrop remains very difficult and continues to argue for a cautious portfolio position from the perspective of credit exposure. We continue to look out for signs that the labour market may be weakening, or that demand for goods and services may softening, which would signal that we are approaching the peak of inflation expectations and that Central Banks and market may start focusing on recession risks. Under such circumstances we would increase our duration position, but those signs have yet to come through.

Absolute Return Bond Plus Fund

Performance:
Over the quarter, the L&G Absolute Return Bond Fund (Z share class Acc.) delivered a performance of -7.50%, versus the comparator benchmark ICE BofA USD 3 Month Deposit Offered Rate Constant Maturity Total Return Index Total Return Index's return of -7.46%, an underperformance of -0.04%. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Our active rates strategies contributed to performance as we took advantage of large moves in the Rates market. Firstly, we increased duration in July, as we believe that Central Banks would start worrying about recession more than inflation. We took profit as this view materialised, and rates briefly rallied. Then. we re-instated a short position in August as we believe the focus would return to inflation, and we held that position until the end of the quarter. This was very beneficial to the portfolio as government bond yields rose sharply.

Our credit hedges contributed to performance as Credit-Default Swap Indices widened.

Key negative contributors:

On the other hand, our diversified exposure to corporate bonds detracted from performance as those continued to sell-off amidst the turmoil in rates markets

Our active credit strategies also detracted from performance. Exposures to Cocos continued to come under pressure as the ECB continued to tighten monetary policy to curb inflation, while Real Estate Hybrid corporate bonds outperformed.

Positioning:
Over the quarter, we have maintained a credit exposure between neutral (in July) and defensive (by end September). We have reduced credit risk in the fund, predominantly in the Pan-European space, we have mitigated the impact of our exposure by moving up in quality, particularly in the Coco space where we have swapped long call, lower quality banks for short call, higher quality banks.

We continue to hold a large cash buffer which we are looking to deploy to purchase high quality credit bonds which have severely repriced so far this year

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Active Corporate Bond All Stocks

Performance:
Over the quarter, the Active Corporate Bond-All Stocks-Fund delivered a total return of -10.49%, versus the comparator benchmark of the Markit iBoxx Sterling Non-Gilts Index's total return of -11.01%, hence delivered an outperformance of 0.51% for the period. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Our defensive positioning - neutral to underweight in credit – contributed as sterling credit underperformed other credit markets particularly in September

The rates positioning also contributed as we adjusted the fund's duration to be underweight taking advantage of the large moves in the Gilts market. Ten-year gilt yields rose dramatically through the period, from 2.2% to 4.1% over the quarter, touching 4.5% in the last week of the September

We also took advantage of the relative cheapness of EUR credit markets in July which suffered on the gas shutdown news to selectively add some risk (hedged back into Sterling). The tactical position was reversed early August contributing to the performance of the fund

Key negative contributors:

An overweight positioning in banks detracted from performance as financials underperformed non-financials due to supply and their sensitivity to growth

Overweight in Credit Suisse particularly detracted negatively given news flow but we remain moderately positive on the name due to its strong liquidity position and capital ratios are much higher than during the global financial crisis. Debt reduction in the form of a bond tender was announced early October which was supportive.

Positioning:

Over Q3, we stayed cautious overall on credit with portfolio's beta positioning close to neutral in line with our credit scores

We maintained an overweight in banks against underweight to the Bank of England Corporate Bond names although have reduced the underweight.

Towards the end of September, we used the market weakness and added selectively on attractive valuations as Sterling credit spreads widened towards the June wide level.

We maintained a small, short duration position throughout the period as inflation proved much more persistent with the energy crisis and central banks' hawkish policy but recognise that by now substantial policy moves are priced in

Active Corporate Bond Over 10 Year

Performance:
Over the quarter, the Active Corporate Bond-Over 10 year-Fund delivered a total return of -17.01%, versus the comparator benchmark of the Markit iBoxx Sterling Non-Gilts 10+ year Index's total return of -16.93%, hence delivered an underperformance of 0.08% for the period. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Our defensive positioning – c5% underweight in credit - contributed positively as sterling credit underperformed other credit markets particularly in September

We also took advantage of the relative cheapness of EUR credit markets in July which suffered on the gas shutdown news to selectively add some risk (hedged back into Sterling). The tactical position was reversed early August contributing to the performance of the fund

The rates positioning also contributed as we adjusted the fund's duration to be underweight taking advantage of the large moves in the Gilts market. Ten-year gilt yields rose dramatically through the period, from 2.2% to 4.1% over the quarter, touching 4.5% in the last week of the September

Key negative contributors:

The key detractor was led by the continued and sustained Sterling rate curve flattening which saw 2-year gilts yields rise more than their long end counterparts: 2yr rose by 2.39% to 4.23% over the quarter whilst 30-year gilts rose 1.26% to 3.83% as markets continued to expect more rate hikes from the Bank of England as they disappointed with only a 50bps hike early September. This impacted the portfolio negatively given its overweight in the intermediary part of the curve and underweight at the long end.

In addition, the announcement of the unfunded 'mini budget' on 23 September led to extreme levels of volatility in the Gilts market which impacted September month-end bond prices. Overall, we believe these marks impacted the portfolio performance to the downside on September 30th which fortunately was reversed fully in early October.

An overweight positioning in banks detracted from performance as financials underperformed non-financials due to supply and their sensitivity to growth

Overweight in Credit Suisse particularly detracted negatively given news flow but we remain moderately positive on the name due to its strong liquidity position and capital ratios are much higher than during the global financial crisis. Debt reduction in the form of a bond tender was announced early October which was supportive.

Positioning:

Over Q3, we stayed cautious overall on credit with portfolio's beta positioning still underweight.

We maintained an overweight in banks against underweight to the Bank of England Corporate Bond names although have reduced the underweight.

Towards the end of September, we used the market weakness and added selectively on attractive valuations as Sterling credit spreads widened towards the June wide level.

We maintained a short duration position throughout the period as inflation proved much more persistent with the energy crisis and central banks' hawkish policy but recognise that by now substantial policy moves are priced in.

Active GBP Collateralised and Corporates Fund

Performance:
Over the quarter, the Active GBP Collaterised and Corporates Fund delivered a total return of -11.56%, versus the comparator benchmark of the Markit iBoxx Sterling Collaterised and Corporates Index's total return of -11.90%, hence delivered an overperformance of 0.33% for the period. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Credit selection and defensive positioning contributed positively as sterling credit underperformed other credit markets particularly in September

We also took advantage of the relative cheapness of EUR credit markets in July which suffered on the gas shutdown news to selectively add some risk (hedged back into Sterling). The tactical position was reversed early August contributing to the performance of the fund

The rates positioning also contributed as we adjusted the fund's duration to be underweight taking advantage of the large moves in the Gilts market. Ten-year gilt yields rose dramatically through the period, from 2.2% to 4.1% over the quarter, touching 4.5% in the last week of the September

Key negative contributors:

An overweight positioning in banks detracted from performance as financials underperformed non-financials due to supply and their sensitivity to growth

Overweight in Credit Suisse particularly detracted negatively given news flow but we remain moderately positive on the name due to its strong liquidity position and capital ratios are much higher than during the global financial crisis. Debt reduction in the form of a bond tender was announced early October which was supportive

Positioning:

Over Q3, we stayed cautious overall on credit

We maintained an overweight in banks against underweight to the Bank of England Corporate Bond names although have reduced the underweight.

Towards the end of September, we used the market weakness and added selectively on attractive valuations as Sterling credit spreads widened towards the June wide level.

We maintained a short duration position throughout the period as inflation proved much more persistent with the energy crisis and central banks' hawkish policy but recognise that by now substantial policy moves are priced in.

Outlook:

The final week of the quarter ushered in a tumultuous period for UK markets. Chancellor Kwasi Kwarteng's mini budget, announced on 23 September and featuring plans for unfunded tax cuts, had an unsettling effect on investors. Sterling fell – briefly to its lowest level ever against the US dollar – and gilt yields rose. With the economy facing headwinds, the BoE launched an emergency bond-buying scheme that will see the bank purchase 30-year gilts totalling £65 billion through 14 October. Previously announced plans to sell £80 billion in bonds per month were pushed further into autumn. Additionally, the central bank indicated interest rates would have to rise higher than previously anticipated
The fall out of the mini budget announcement had some contagion to Sterling credit markets as expected. As not only credit spreads but also interest rates reached new highs for the year, the yield on the Sterling investment grade credit index went up to well above 7% - levels we haven't witnessed since 2009. While we view these levels as attractive, we continue to cautiously position portfolios holding sufficient liquidity. On the geopolitical front, while much of the focus remains on Ukraine and European energy security, the upcoming China Party Congress could be important for the country's COVID policy as well as more stimulus to offset the property sector's weakness.

Buy and Maintain

The portfolio return was negative for the third quarter as yields rose and credit spreads widened. A tumultuous few days followed the 'mini-budget in the UK where the gilt market experienced a very sharp rise in nominal and real yields. The pound also fell to its lowest level ever versus the US dollar. The market took fright from the biggest set of unfunded tax cuts in half a century, assuming that the increased fiscal burden, combined with already heightened inflation and a fragile economy, would mean the Bank of England (BoE) would have to raise interest rates significantly in the near-term. The selloff eventually prompted the BoE to step in and support the long end of the UK gilt market.

The significant rise in gilt yields led to UK Defined Benefit Schemes with leveraged hedging strategies scrambling for liquidity to replenish collateral buffers in order to maintain hedge ratios. To put this into context, the yield on the 30-year gilt increased from 3.7% on early morning Friday 23rd September to over 5% by mid-morning on Wednesday 28th. Those with formal liquidity ladders in place turned to those to raise cash. Others with less formal plans in place turned to their most liquid assets, including investment grade credit to raise cash. As a result, investment grade spreads widened 0.5% in the UK and 0.4% in the US in the days following the budget.

Monetary policy tightened during the quarter. The US Federal Reserve raised rates from 1.75% to 3.25%, the ECB from zero to 1.25% and the Bank of England from 1.25% to 2.25% over the quarter. The expectation is for central banks to continue to tighten monetary policy. Our central case is that UK base rates reach over 4% and the Fed Funds rate will get to 4.75% by early 2023. With the potential for aggressive rates increases ahead, the likelihood of a hard landing and subsequent recession increase as we head into late 2023.

Core Plus Fund

Performance:
Over the quarter, the L&G Core Plus Bond Fund (C share class Acc.) delivered a performance of -9.65%, versus the comparator benchmark iBoxx Sterling Non-Gilts Total Return Index's return of -11.01%, an outperformance of 1.36%. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Our active rates strategies contributed to performance as we took advantage of large moves in the Rates market. Firstly, we increased duration in July, as we believe that Central Banks would start worrying about recession more than inflation. We took profit as this view materialised, and rates briefly rallied. Then. we re-instated a short position in August as we believe the focus would return to inflation, and we held that position until the end of the quarter. This was very beneficial to the portfolio as government bond yields rose sharply.

Our credit allocation was beneficial as we had maintained an underweight in Sterling Corporates, which underperformed other credit markets

Key negative contributors:

Our active credit strategies also detracted from performance. Exposures to Cocos continued to come under pressure as the ECB continued to tighten monetary policy to curb inflation, while Real Estate Hybrid corporate bonds outperformed.

Positioning:
Over the quarter, we have reduced credit risk in the fund, predominantly In the Pan-European space, we have mitigated the impact of our overweight exposure by moving up in quality, particularly in the Coco space where we have swapped long call, lower quality banks for short call, higher quality banks.

We have marginally increased our overweight in US Dollar Credit through the purchase of new issues at attractive levels.

We have been active in our management of duration as we described in the Performance section of this document. As we approached the end of the quarter, we simplified our book of Rates & Inflation positions, but we have started building a long exposure to 10-Year gilts as we believe that recession expectations will be brought forward given market concerns on concerns over the UK government's fiscal policy.

Outlook:
Looking ahead, the most important market driver remains central bank policy. But with the US economy appearing robust and inflation remaining elevated, dovish policy relief appears some time away. In the meantime, rising

bond yields and a strong US dollar will keep pressure on leveraged entities. Geopolitically, while much of the focus remains on Ukraine and European energy security, the upcoming China Party Congress could be important for the country's COVID policy as well as more stimulus to offset the property sector's weakness. In sum, while valuations continue to cheapen, the macro backdrop remains very difficult and continues to argue for a cautious portfolio position from the perspective of credit exposure. We continue to look out for signs that the labour market may be weakening, or that demand for goods and services may softening, which would signal that we are approaching the peak of inflation expectations and that Central Banks and market may start focusing on recession risks. Under such circumstances we would increase our duration position, but those signs have yet to come through.

Global Corporate Bond Fund

Performance:
Over the quarter, the L&G Global Corporate Bond Fund (C share class Acc.) delivered a performance of -2.44%, versus the comparator benchmark Bloomberg USD/EUR/GBP Corporates 1% issuer capped Total Return Index's return of -1.75%, an outperformance of +0.69%. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

Our active rates strategies contributed to performance as we took advantage of large moves in the Rates market. Firstly, we increased duration in July, as we believe that Central Banks would start worrying about recession more than inflation. We took profit as this view materialised, and rates briefly rallied. Then. we re-instated a short position in August as we believe the focus would return to inflation, and we held that position until the end of the quarter. This was very beneficial to the portfolio as government bond yields rose sharply.

Our credit allocation was beneficial as we had maintained an overweight in European Corporates, Global High Yield and Emerging Market Debt which all fared better than Sterling and US Dollar Corporates.

Key negative contributors:

Our active credit strategies also detracted from performance. Exposures to Cocos continued to come under pressure as the ECB continued to tighten monetary policy to curb inflation, while Real Estate Hybrid corporate bonds outperformed.

Positioning:
Over the quarter, we have sought to cover our underweight in US Dollar Credit through the purchase of new issues at attractive levels.

In the Pan-European space, we have mitigated the impact of our overweight exposure by moving up in quality, particularly in the Coco space where we have swapped long call, lower quality banks for short call, higher quality banks.

We have been active in our management of duration as we described in the Performance section of this document. As we approached the end of the quarter, we simplified our book of Rates & Inflation positions, but we have started building a long exposure to 10-Year gilts as we believe that recession expectations will be brought forward given market concerns on concerns over the UK government's fiscal policy.

Outlook:

Looking ahead, the most important market driver remains central bank policy. But with the US economy appearing robust and inflation remaining elevated, dovish policy relief appears some time away. In the meantime, rising bond yields and a strong US dollar will keep pressure on leveraged entities. Geopolitically, while much of the focus remains on Ukraine and European energy security, the upcoming China Party Congress could be important for the country's COVID policy as well as more stimulus to offset the property sector's weakness. In sum, while valuations continue to cheapen, the macro backdrop remains very difficult and continues to argue for a cautious portfolio position from the perspective of credit exposure. We continue to look out for signs that the labour market may be weakening, or that demand for goods and services may softening, which would signal that we are approaching the peak of inflation expectations and that Central Banks and market may start focusing on recession risks. Under such circumstances we would increase our duration position, but those signs have yet to come through.

Index-Linked Bond Fund

Performance:

Over the quarter, the Index-Linked Bond Fund delivered a performance of -8.76%, versus the comparator benchmark FTSE Index Linked over 5 Years Total Return Index's return of -10.59%, an outperformance of 1.83%. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

We took advantage of the volatility in Rates market during the quarter. Firstly, we increased duration in July, as we believe that Central Banks would start worrying about recession more than inflation. We took profit as this view materialised, and rates briefly rallied. Then. we re-instated a short position in August as we believe the focus would return to inflation, and we held that position until the end of the quarter. This was very beneficial to the portfolio as government bond yields rose sharply.

We had a short position in Italian government bonds versus long positions in other peripheral bonds as we were concerned that higher yields would put pressure on the sustainability of the Italian public debt. Markets shared our concerns, which were exacerbated by the victory of the far-right in the Italian elections in September.

Our long position in Australian rates versus US Treasury contributed to returns as our long-term view that the Australian economy was more sensitive that the US played out, with monetary policy tightening more in the US than Australia

We sold gilts versus bunds in August, as we believed the risk of unconventional economic policy announcements by the new government was not priced by markets. That view played out quicker than expected and we took profit during the quarter

Key negative contributors:

On the other hand, our long German bunds versus US Treasuries marginally detracted from performance as European government signalled strong fiscal support as a response of the rise in the cost of living, which we expect will dampen the risks of recession in Europe.

Our long position in EU bonds detracted from returns are those sold off through the quarter amidst high volatility

Positioning:
We have been active in our management of duration as we described in the Performance section of this document. As we approached the end of the quarter, we simplified our book of positions, but we have started building a long exposure to 10-Year gilts as we believe that recession expectations will be brought forward given market concerns on concerns over the UK government's fiscal policy.

We have reduced some our relative value positions which played out, such as our long exposure in Australia government bonds versus US Treasuries.

We maintain our short position in Italian government bonds, and we are worried about the sustainability of Italian debt given higher yields and uncertainty around the policies of the new government.

We have sold Japanese government bonds as pressures continue to build on BOJ to give up on yield curve control.

Outlook:
Looking ahead, the most important market driver remains central bank policy. But with the US economy appearing robust and inflation remaining elevated, dovish policy relief appears some time away. In the meantime, rising bond yields and a strong US dollar will keep pressure on leveraged entities. Geopolitically, while much of the focus remains on Ukraine and European energy security, the upcoming China Party Congress could be important for the country's COVID policy as well as more stimulus to offset the property sector's weakness. In sum, while valuations continue to cheapen, the macro backdrop remains very difficult and continues to argue for a cautious portfolio position. We continue to look out for signs that the labour market may be weakening, or that demand for goods and services may softening, which would signal that we are approaching the peak of inflation expectations and that Central Banks and market may start focusing on recession risks. Under such circumstances we would increase our duration position, but those signs have yet to come through. We continue to focus on relative value positions, with exposure to countries with more rates-sensitive economies, such as Australia, as well as looking for opportunities in countries which are under pressure from global inflation and hiking cycles, such as Japan.

Secure Income Assets Fund

Against a highly volatile backdrop from both macroeconomic and markets perspectives, we were able to take advantage of spread widening to increase our exposure to high quality issuers. During the period, we made investments in four investment grade transactions. These were for a portfolio of self-storage assets, a mixed-use office scheme in Central London, a modern student accommodation portfolio and a property lease financing guaranteed by a FTSE 100 corporate.

Over the quarter, we saw central banks continue to tighten monetary policy as they combat persistently high inflation. Markets reacted negatively to the UK's fiscal policy mini-budget (now principally reversed) with sterling weakening and gilt yields increasing substantially. This has caused pressure on pension funds that had used leverage to hedge interest rate positions, resulting in significant margin calls.

As we move into Q4, we expect economies to continue to slow with some entering into recession. Credit spreads have drifted closer to Covid highs as the recession becomes the base scenario and fiscal and monetary policy come to odds in the UK. Our position is to avoid credits with significant/excessive consumer (specifically, discretionary) risk and an inability to manage inflation and/or pass-through inflating costs. We continue to operate with a natural defensive bias, avoiding sectors highly correlated to economic cycles. Importantly, we believe the need for both asset diversification, particularly in resilient credit, continues. Our decision to target shorter duration assets given expectations of rates rises has seen the Fund outperform versus broader public credit markets.

UK Fixed Interest All Stocks

Performance:
Over the quarter, the UK Fixed Interest - All Stocks – Fund delivered a performance of -11.88%, versus the comparator benchmark FTSE UK Gilts All Stocks Total Return Index's return of -12.92%, an outperformance of 0.96%. Performance is gross of fees; the effect of fees and charges would reduce the returns shown.

Key positive contributors:

We took advantage of the volatility in Rates market during the quarter. Firstly, we increased duration in July, as we believe that Central Banks would start worrying about recession more than inflation. We took profit as this view materialised, and rates briefly rallied. Then. we re-instated a short position in August as we believe the focus would return to inflation, and we held that position until the end of the quarter. This was very beneficial to the portfolio as government bond yields rose sharply.

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Multi Asset

Diversified Fund

Market conditions:
The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous 'mini budget' which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Turning to alternative investments, REITs had a particularly poor quarter with the real estate market beginning to feel the strain of rising rates. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

The DF returned -2.6% over the quarter. Its long-term comparator of developed global equities (as measured by the FTSE Developed World Index, 50% hedged to GBP) returned -1.5%. Since inception the DF has returned + 6.8% p.a. Realised returns for the long-term comparator (FTSE Developed World Index, 50% hedged to GBP) were +11.0% p.a. Our long-term return expectation (for both developed equities as well as for the Diversified Fund) is around risk-free rates +3.5-4% or c. 4.2% since inception. We don't expect the DF to match equity returns in an extended market rally given the DF's diversified composition and in general expect the DF to outperform equities in a downmarket given its diversified asset allocation.
The fund's realised volatility since inception reflects 64% of the volatility of its long-term comparator, developed global equities (as measured by the FTSE Developed World Index, 50% hedged to GBP). This is in line with the fund's volatility target.

Contributions to Fund Return:
Most asset classes delivered negative returns over the quarter. Emerging Market Debt (local), North American Equities and Global Small Cap were the main positive contributors to performance over the quarter. On the other side, US and UK credit had the largest negative contribution to fund performance. Real Estate (REITs) and EM equities had smaller negative contributions to performance over the quarter.

Fund Positioning:
There were no changes to the strategic asset allocation over the quarter.

Dynamic Diversified Fund

Market conditions:

The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous 'mini budget' which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Turning to alternative investments, REITs had a particularly poor quarter with the real estate market beginning to feel the strain of rising rates. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

Contributors		Detractors	
Overseas Currency	1.28%	GBP Non-Gilts	-0.62%
Risk Management	0.23%	Global Real Estate	-0.50%
Global Inflation-Linked Bonds	0.17%	Emerging Market Equity	-0.37%
Rates hedges	0.12%	Min Vol	-0.27%
		Global Infrastructure	-0.25%

The DDF returned -2.35% over the quarter. This takes since inception performance to 5.3% p.a. versus the objective of 5.0%.

Contributions to Fund Return:

In terms of broad asset classes, Investment Grade and Alternative Credit, Listed Alternatives, and Equities accounted for roughly similar detractions from return. UK Credit and REITS were the largest single asset classes detractors over the quarter, impacted by rising interest rates and the announcement of the 'mini budget' in the case of the former.

Foreign Currency exposure, in particular the US dollar, was the main positive contributor to performance as the pound declined vs. other currencies. Option positions in equities added 0.23% to fund return. Hedges to reduce sensitivity to bond yield moves also added to returns.

Fund Positioning:

Within the DDF we made the following changes over the quarter:

Equities. We entered Q3 with a higher overall equity weight and no option protection, with the view that the bad news for equities had largely been priced into markets. As markets recovered mid-quarter we removed this tactical position and closed our long position in the US energy sector. We also added to equity option protection as markets rallied, up to 5.5%, and only at the end of the quarter reduced to 3.5%, while substituting equivalent reductions in equities.

Government bonds. Early in the quarter, we reduced UK gilts relative to German bunds on concerns that investors in UK government bonds would disfavour the large fiscal announcements coming from the contenders for new Prime Minister. We removed this position after under-performance of gilts, and also reduced our preference to Australian and Canadian bond position as yields there were more stable than sell-offs elsewhere. We began to reduce the size of our lower duration position in US bonds as the market priced in more hikes, though retain some of this given that further rate hikes are likely to destabilise risk markets further.

Inflation. Early in the quarter, we added to both US and European inflation-linked bonds primarily due to improved valuations. Towards the end of the quarter, we upgraded our view on UK inflation-linked Bond exposure and look to incrementally add upon further weakness.

Currency. After the mini-budget, we saw a significant sell-off in the pound and at times market panic. We sought to push against this panic and added to the pound against the euro and Australian dollar over the quarter.

Liquidity. Like many funds used by UK DB schemes, the DDF has had outflows over the quarter. There were no difficulties in providing this in terms liquidity, reducing most holdings proportionately.

Outlook:

The market environment has become increasingly unfavourable of late, leading us to reduce our overall view on risk assets from marginally positive to neutral. We further reduced our already negative view on the economy due to the ongoing squeeze on UK interest rates and the increasingly unaccommodating stance of global central banks. We also cut our view on systemic risk from neutral to slightly negative, partly due to the increase in the vulnerability of the global housing market due to rising rates. Against those headwinds, two factors keep our overall view neutral rather than negative; we believe valuations already reflect a lot of bad news and we continue to see very weak investor sentiment giving scope for some relief to the rout.

In the UK, the fiscal boost offered by the Energy Price Guarantee (EPG) announcement in the mini budget led us to push out the timing of the recession in the UK. The EPG's most significant effect will be on inflation, where we now believe CPI will peak at just over 10%, compared to around 15% without the cap. In our assessment, a UK recession similar in magnitude to the 1990s seems most likely, i.e. a peak-to-trough decline of around 2%. Other European governments have also acted to limit the impact of the energy price squeeze. Collectively, Europe faces a challenging task to reduce gas usage or face increasing risks of shortages, and on balance measures to keep consumer prices down will not help to reduce demand. We expect a normal size recession in Europe and the UK around the turn of the year, with the central banks expected to keep tightening until growth fears exceed inflation worries. In the US, we have increased our probability of a recession in 2023, with the possibility of a soft landing becoming more challenging the longer it appears inflation isn't reacting to higher interest rates.

We have gradually reduced risk in our portfolios in recent months, and portfolios will continue to reduce allocations to risky assets to achieve our neutral stance. Despite this overall picture, we have recently seen an increase in the relative attractiveness of investment grade credit. This is particularly the case for European credit where spreads are now slightly wider than the 75th percentile of spreads that we've seen in the last 15 years.

Diversified Multi-Factor Equity Fund

Market review:

The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous ‘mini budget’ which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

Fund review:

The diversified multi-factor equity fund was down -2.2% in the third quarter of 2022, whilst its comparator was down -2.0%.

This brings the fund return since inception to 4.7% p.a. which is behind the comparator which returned 5.8% p.a.

Performance drivers:

Within the UK and emerging markets, the largest stocks in their respective investible universe outperformed throughout the quarter. Banks and other financials feature prominently within the largest stocks of both regions, with higher government bond yields globally causing banks to outperform. Therefore the diversified weighting scheme of the fund detracted over the quarter, in particular within the UK and EM.

Factors again contributed positively to performance, though by less than in previous quarters. Low volatility performed well over the quarter, assisted by the relative outperformance of defensive sectors which make up a higher proportion of low volatility strategies than the broader market.

As equity markets were again somewhat lower over the period, the fund’s lower market exposure (as measured by beta) added to the overall fund performance, though by less than in previous quarters this year.

Euro Diversified Fund

Market conditions:
The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous 'mini budget' which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Turning to alternative investments, REITs had a particularly poor quarter with the real estate market beginning to feel the strain of rising rates. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

The EDF returned -4.57% over the quarter. Its long-term comparator of developed global equities (as measured by the FTSE Developed Index, 50% hedged to EUR) returned -2.53%. Since inception the EDF has returned +3.36% p.a. Realised returns for the long-term comparator (FTSE Developed Index, 50% hedged to EUR) were +7.74% p.a. Our long-term return expectation (for both developed equities as well as for the EDF) is around risk-free rates +3.5-4% or c. 3.27% since inception. We don't expect the EDF to match equity returns in an extended market rally given the EDF's diversified composition and in general expect the EDF to outperform equities in a downmarket given its diversified asset allocation.
The fund's realised volatility since inception reflects 64% of the volatility of its long-term comparator, developed global equities (as measured by the FTSE Developed Index, 50% hedged to EUR). This is in line with the fund's volatility target.

Contributions to Fund Return:
Most asset classes detracted from performance over Q3 2022. Few small positive contributions came from Global Small Cap, Emerging Market Debt (local) and North American Equities. On the other side, US and UK Credit, Real estate investment trusts and Infrastructure detracted the most from performance.

Fund Positioning:
There were no changes to the strategic asset allocation over the quarter.

Euro Dynamic Diversified Fund

Market conditions:

The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous 'mini budget' which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Turning to alternative investments, REITs had a particularly poor quarter with the real estate market beginning to feel the strain of rising rates. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

The EDDF returned -3.2% over the period. This takes since inception performance to 4.8% p.a. versus the objective of 3.7% p.a.

Contributions to Fund Return:

In a tough quarter for all assets, a large proportion of holdings detracted from returns with Infrastructure and REITs the largest detractors, with the real estate market beginning to feel the strain of rising rates. Gold mining and forestry stocks also declined, giving back gains from the previous quarter.

The main positive contributions to performance came from overseas currency as the euro declined versus other currencies, in particular the US dollar. Risk management strategies including options also contributed positively to help cushion declines across the portfolio.

Fund Positioning:

Within the EDDF we made the following changes over the quarter:

Equities. We entered Q3 with a higher overall equity weight after we went tactically long at the end of June as we saw bad news for equities had largely been priced into markets. Given the investment case played out and we saw strong performance on the back of it, we reduced this somewhat towards the end of July. We also added option protection on Chinese equities to insulate the funds in the event of what we believed to be an increasing risk that Chinese assets will see a heightened risk premium after the UN report on China abuse of human rights.

Government bonds. We closed our long standing position in Czech government bonds. Overall the position did not perfrom as we'd have hoped, with the Czech National Bank grappling one of the worst inflation problems in the developed world. However, the last few quarters have offered significant respite, with significant spread tightening to German bunds. We now feel that there is an increased risk that the Czech National Bank becomes more hawkish once more and pushes us to close the trade.

Currency We reduced exposure to Japanese yen whilst increasing exposure to the US dollar, implemented via options, which has proven to be one of the few assets that has performed strongly so far this year.

Outlook:
The market environment has become increasingly unfavourable of late, leading us to reduce our overall view on risk assets from marginally positive to neutral. We further reduced our already negative view on the economy due to the ongoing squeeze on UK interest rates and the increasingly unaccommodating stance of global central banks. We also cut our view on systemic risk from neutral to slightly negative, partly due to the increase in the vulnerability of the global housing market due to rising rates. Against those headwinds, two factors keep our overall view neutral rather than negative; we believe valuations already reflect a lot of bad news and we continue to see very weak investor sentiment giving scope for some relief to the rout.

In the UK, the fiscal boost offered by the Energy Price Guarantee (EPG) announcement in the mini budget led us to push out the timing of the recession in the UK. The EPG's most significant effect will be on inflation, where we now believe CPI will peak at just over 10%, compared to around 15% without the cap. In our assessment, a UK recession similar in magnitude to the 1990s seems most likely, i.e. a peak-to-trough decline of around 2%. Other European governments have also acted to limit the impact of the energy price squeeze. Collectively, Europe faces a challenging task to reduce gas usage or face increasing risks of shortages, and on balance measures to keep consumer prices down will not help to reduce demand. We expect a normal size recession in Europe and the UK around the turn of the year, with the central banks expected to Keep tightening until growth fears exceed inflation worries. In the US, we have increased our probability of a recession in 2023, with the possibility of a soft landing becoming more challenging the longer it appears inflation isn't reacting to higher interest rates.

We have gradually reduced risk in our portfolios in recent months, and portfolios will continue to reduce allocations to risky assets to achieve our neutral stance. Despite this overall picture, we have recently seen an increase in the relative attractiveness of investment grade credit. This is particularly the case for European credit where spreads are now slightly wider than the 75th percentile of spreads that we've seen in the last 15 years, so we have increased exposure here.

Future World Multi-Asset Fund

The Future World Multi-Asset Fund returned -3.3% over the quarter versus its formal comparator (ABI 40-85% sector) which returned -1.7%. The fund has returned 2.7% p.a. since inception (June 2018) versus the sector which has returned 2.1% p.a. The fund's realised volatility since inception is 9.4% and reflects 59.8% of the volatility of its long-term comparator, developed global equities (as measured by the FTSE Developed World Index, 50% hedged to GBP). This is slightly below the fund's volatility target.

Market Conditions:
The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous 'mini budget' which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates

much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Turning to alternative investments, REITs had a particularly poor quarter with the real estate market beginning to feel the strain of rising rates. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

Contributions to Fund Return:
UK Credit, US Credit and Real Estate Investment Trusts were the main asset class detractors to performance over the quarter. Emerging Market Debt (local currency) and exposure to foreign currency, particularly the US dollar as the pound weakened over the quarter, were the main contributors. The overall contribution from foreign currency exposure was just over 2% at fund level, demonstrating the value of this exposure in current conditions.

Fund Positioning:
During the quarter we reduced exposure to the standard infrastructure index fund and added to the basket of equities for infrastructure which include network, water and renewable energy companies, they have a higher ESG score and stronger sustainability characteristics. This takes the composition of our listed infrastructure holding to 50% via standard index and 50% via the sustainability-focused basket. We also increased the social purpose real estate investment trust basket to include two new names previously on our watchlist, both of these companies provide supported housing to people with long-term care and support needs. These companies have made progress in helping the sector achieve a more robust operating model by addressing issues with lease lengths and a mismatch of liabilities and income.

We also incrementally increased our holding in green government bonds and other sustainable bonds after the UK green gilt (2033) moved to offer a positive yield pickup over comparable standard gilts and to take advantage of new issuance by global vaccination funder IFFIM.

Multi-Asset Fund

Market conditions:
The penultimate quarter of the year started positively for risky assets and bonds alike, but again turned sour in the closing weeks adding to pain from the first half of the year. The promising start was fuelled by strong earnings and an investors gaining confidence that the US Federal Reserve could tame inflation with its monetary policy. The narrative on this shifted towards the end of the period with US inflation surprising to the upside, leading to increased interest rate expectations in the US. In Europe, the quarter saw new leaders installed for both Italy and the UK. The new UK government quickly announced a momentous 'mini budget' which sparked a rout in markets with the pound falling to multi-decade lows and gilt yields rocketing higher. This prompted the Bank of England (BOE) to step in and steady the UK gilt market with a fresh asset purchasing programme. Over the quarter, 10 year gilt yields rose from 2.2% to nearly 4.1%, and investors are now expecting the Bank of England to raise rates much faster and further than previously expected. Inflation linked bonds also suffered heavily as pension funds unwound holdings.

Global equites generally saw weak performance over the quarter, struggling in the face of tightening monetary conditions and the prospect of recession. Meanwhile, both sovereign and corporate bonds also fell victim to the increasingly hawkish stance of central bankers, posting mostly very weak returns. Turning to alternative investments, REITs had a particularly poor quarter with the real estate market beginning to feel the strain of rising rates. Even commodities lost their lustre, handing back some gains from earlier in the year as slowing growth prospects and continues woes in the Chinese economy weighed down the asset class. The dollar continued its dominance of 2022, proving its credentials as a safe haven harbour during a storm in markets.

The Multi-Asset Fund returned -3.1% over the quarter versus its formal comparator (ABI 40-85% sector) which returned -1.7%. It has returned +6.4% p.a. since inception compared to its formal comparator ABI which has returned 5.8% p.a.. The fund's realised volatility since inception is 7.9% and reflects 67% of the volatility of its long-term comparator, developed global equities (as measured by the FTSE Developed World Index, 50% hedged to GBP). This is in line with the fund's volatility target.

Contributions to Fund Return:
Most asset classes experienced negative returns over the quarter. North American equities, Emerging Market Debt (local) and Global Small Cap were the main positive contributors to performance over the quarter. On the other side, UK Credit and US Credit detracted most from performance. Real Estate (REITs), UK Inflation Linked bonds and Emerging Market Equities contributed negatively towards performance over the quarter as well.

Fund Positioning:
There were no changes to the strategic asset allocation of the fund during the quarter.

Retirement Income Multi-Asset Fund

RIMA's return was -2.6% over the period. The main asset contributions to performance came from Overseas currency (+0.6%), UK Inflation Linked Bonds (+0.4%) and Risk management strategies (+0.2%). Global real estate investment trusts (-0.6%), UK Corporate Bonds (-0.6%) and Global Infrastructure (-0.4%) detracted from performance.

Largest Contributors		Largest Detractors	
Overseas currency	0.60%	Global REITs	-0.57%
UK Inflation Linked Bonds	0.39%	UK Corporate Bonds	-0.57%
US Nominal Treasuries	0.19%	Global Infrastructure	-0.43%
Risk Management	0.17%	EU Nominal Government Bonds	-0.34%
UK Nominal Sovereign Bonds	0.09%	Emerging Market Equities	-0.28%

Equities and Alternatives. We entered Q3 with a higher overall equity weight after we went tactically long at the end of June. We reduced this somewhat towards the end of July; split across Japan, US technology and small cap stocks (-1% in total) after risk assets rose sharply. Since then, we've added put option protection over the quarter across the US, Japan and Emerging markets (around 4% in total). These options have increased in value as markets have fallen lower throughout August and September which has therefore lowered the overall risk in the fund as markets sold off. This reduction in risk is in-line with our now neutral view of overall risk in the fund.

Government bonds. We started the quarter at around 3.4 years duration which is lower than average since inception. We cut this to c.3.1 years in late July following a substantial rally in bonds and on diversification grounds, as we have seen an increasing correlation between equities and bonds. Furthermore, we then added back 0.3 years in mid-September as a result of higher yields and reduced conviction in our view on the equity-bond correlation going-forward.

Earlier in the quarter and closer to home, we had sold UK gilts relative to German bunds on concerns that investors in UK government bonds would disfavour the large fiscal announcements coming from the contenders for new Prime Minister. We did indeed see a sell-off in gilts relative to other markets so increased gilts (+2.2%) and sold bunds (-2.2%) in August. In duration terms we had cut UK duration close to zero at its low point (0.15yrs), we then increased this to near +1yrs at the end of September. This meant that towards the end of the quarter, we raised duration in the fund by approximately 0.5yrs, predominantly in gilts, following confirmation that the Bank of England was intervening within the gilt market to restore more normal market conditions.

Inflation. Early in the quarter, we added significantly to both US (+1.5%) and European (+1%) inflation-linked bonds primarily due to improved valuations. Markets then changed rapidly with real yields dropping back sharply. As the trade rationale played out faster than expected we closed both positions (-2.5% combined). Towards the end of the quarter we saw a significant sell-off in index-linked gilts and at times dysfunctional market conditions. After the Bank of England had committed to intervene we went long long-dated index-linked gilts (+1%) as we felt they offered attractive value once market conditions had normalised somewhat.

However, the sharp rise in inflation-linked bond yields over the quarter has led to further analysis around their structural allocation within RIMA going forward. For years, we have avoided meaningful exposure to UK and global inflation-linked debt due to valuation concerns. Given the sharp repricing in recent months, we are starting to re-evaluate. Right at the end of the quarter we took the small step outlined above, but this may be something we look to add to more significantly in the coming months.

Currency. The typical foreign exchange exposure in RIMA is around 22-23% and so a strong GBP is therefore a headwind for the fund. We manage outcome risk by pushing against bouts of sterling weakness. We entered the quarter with an existing long GBP position (c.2%). In addition we introduced a further long GBP position implemented via options (2%) which would pay off if the pound strengthened. After the mini-budget, we saw a significant sell-off in GBP and at times market panic. We sought to push against this panic and added to GBP (+1%) against the euro and yen at the end of the quarter. That latest increase was closed out shortly after quarter-end when more normal market conditions were restored.

Corporate bonds. Having been cautious on global investment grade credit since last year, we added around 3% European credit in June. We have become more positive on the asset class on valuation grounds due to the spread widening that is now behind us. We see EU credit as offering particularly attractive valuations and we may look to add to this going forward.

Outlook

The market environment has become increasingly unfavourable of late, leading us to reduce our overall view on risk assets from marginally positive to neutral. We further reduced our already negative view on the economy due to the ongoing squeeze on UK interest rates and the increasingly unaccommodating stance of global central banks. We also cut our view on systemic risk from neutral to slightly negative, partly due to the increase in the vulnerability of the global housing market due to rising rates. Against those headwinds, two factors keep our overall view neutral rather than negative; we believe valuations already reflect a lot of bad news and we continue to see very weak investor sentiment giving scope for some relief to the rout.

In the UK, the fiscal boost offered by the Energy Price Guarantee (EPG) announcement in the mini budget led us to push out the timing of the recession in the UK. The EPG's most significant effect will be on inflation, where we now believe CPI will peak at just over 10%, compared to around 15% without the cap. In our assessment, a UK recession similar in magnitude to the 1990s seems most likely, i.e. a peak-to-trough decline of around 2%. Other European governments have also acted to limit the impact of the energy price squeeze. Collectively, Europe faces a challenging task to reduce gas usage or face increasing risks of shortages, and on balance measures to keep consumer prices down will not help to reduce demand. We expect a normal size recession in Europe and the UK around the turn of the year, with the central banks expected to Keep tightening until growth fears exceed inflation worries. In the US, we have increased our probability of a recession in 2023, with the possibility of a soft landing becoming more challenging the longer it appears inflation isn't reacting to higher interest rates.

We have gradually reduced risk in our portfolios in recent months, and portfolios will continue to reduce allocations to risky assets to achieve our neutral stance. Despite this overall picture, we have recently seen an increase in the relative attractiveness of investment grade credit. This is particularly the case for European credit where spreads are now slightly wider than the 75th percentile of spreads that we've seen in the last 15 years, so we have increased exposure here.

Real Assets

LPI Income Property Fund

The Fund returned -0.75% in Q3 2022, with performance underpinned by secure income and the capitalisation of RPI linked rental growth.

16 rent reviews were completed in the quarter on an upward only basis. All were reviewed in line with RPI.

In Q3, the Fund completed the disposal of Tesco, Newton-le-Willows. This sale is in line with the strategy of recycling capital from weaker assets with more inherent risk to generate capital to facilitate further investments.

In 2021, the Fund conditionally exchanged contracts to acquire a new headquarters office building in Cardiff. The deal is structured as a forward commitment, conditional on practical completion of the asset. From completion, the property will be let to an investment grade corporate for 25 years with annual rent increases in line with RPI, capped at 5%.

The Fund is actively pursuing additional pipeline assets to facilitate Fund growth and deployment of capital.

All assets that we consider for the Fund's pipeline offer investment grade covenants and are aligned to the Fund's strategy of securing suitable stock, both on and off market, which will deliver appropriate returns while meeting the investment criteria.

The Managed Property Fund

Inflation and the cost of debt dominated investment discourse across all sectors over Q3, which resulted in the Fund delivering -3.1% NAV growth in the quarter and bringing year to date performance to +5.4% (+14.4% over 12 months). Whilst lower yielding assets have been most impacted to date, particularly in the industrial sector, assets with stronger fundamentals in the form of location, environmental credentials and underlying covenants are most likely to offer resilience in the medium term as macro risks increase. The quality of the assets this fund holds means we are well positioned in this regard and, despite headwinds, remain committed to our pipeline of investing in the portfolio to maintain asset quality and relevance.

During the quarter the Fund exited two assets – an industrial distribution unit in Rugby and a multi let industrial estate in Oxford to Big Yellow. The team delivered 18 asset management deals in the quarter which included 6 retail park transactions to occupiers including Pets at Home and DSG (Curry's) and 6 new lettings within the industrial and London office assets.

Our most recent lettings have been in our fully managed and fitted solutions which demonstrates the fast changing market and our ability to adapt to the requirements of office occupiers. Alongside this, we continue to make good progress on our net zero targets, using our net zero carbon roadmaps to engage with our occupiers and improve asset credentials.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

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