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Fund inception
23 May 2017

Threadneedle (Lux) European Social Bond Fund

The fund is designed to balance the three main elements of social outcome, liquidity and financial return and aims to offer European corporate bond risk/return characteristics with the addition of clearly demonstrable social alpha.

The last quarter of 2018 was marked by the market entering a period of risk-off sentiment, with a significant widening of credit spreads resulting in the worst period of underperformance against government bonds since Q3, 2011. Returns were, however, positive as falling government yields helped to drive returns and the fund's defensive positioning helped to deliver outperformance relative to benchmark over the period.

Against a backdrop of tightening monetary conditions, investors were further unsettled by political uncertainty, trade protectionism and concerns about the outlook for global growth. The ECB also ended its bond-buying stimulus programme as planned. Although well expected, the end of the programme comes despite concerns about slowing eurozone growth, Britain's exit from the EU and rising populism in the remaining member states. Largely in anticipation of these conditions, European investment grade was the weakest credit market over 2018 on a risk-adjusted basis. Against this background, the new supply of credit at a discount to market levels has been putting pressure on spreads.

We participated in 10 new issues that came to the market over the quarter. Two of these came from German regional governments – Hamburg and Lower Saxony. Both these new exposures were bonds with general social benefit, adding high quality exposure in Germany to Europe's third largest port and a Federal State with a high proportion of employment in smaller enterprises, which we rated C4 and C3 respectively. We also participated in three issues from specific use-of-proceeds repeat issuers – i.e. issuers that have already issued Social, Green or Sustainability bonds. The largest of these was the second Green Bond from Ireland and represents continued growth from sovereigns in this area. We also invested in the third Social Bond issued by ICO, the Spanish state-owned agency focused on job creation in underperforming regions, which we rate A1. Finally, we added another Social Bond issued by one of the most frequent borrowers of these types of bonds, Nederlandse Waterschapsbank, with the proceeds directed towards social housing projects in the Netherlands, which again received our highest social ranking of A1.

During the quarter we bought two exposures from Inter-America Development Agencies, a new issue from ADB Invest providing financial solutions and advisory services to 330 clients across Latin America and the Caribbean. We also purchased a secondary Social Bond from Inter-America Development Bank from their Education Youth and Employment programme. The bonds from both these issuers, while outside of Europe, provide high social intensity and are rated C1.

The Green bond market continues to develop, not just from large sovereign issues, but also from banks. We participated in a new Green Bond issue from ING Bank, while adding to our position in Green Bonds with purchases of Nordea and IFC. We also invested in the Social Bond issues from BPCE and Kommunalkredit Austria.

France remains the largest exposure with 25% of the portfolio in French domiciled bonds, while we have added to Germany over the period, which is now the second highest exposure in absolute terms. Against this, we have reduced exposure to the UK, Netherlands and Switzerland. Our cash position decreased over the quarter from 2.1% to just under 1.0%, as we exploited new issue opportunities to add social value.

Overall, the social intensity of the fund rose slightly from 17.5% to 17.8% but within this there was a big rise in the impact investments (Category A) within the fund from 19.8% to 21.8%. We held the proportion of the lowest intensity bonds (C3 & C4) below the target of 25% set by the Social Advisory Panel to end the year at 23.8%.

We are running the portfolio to a running yield of 1.06% and an average credit rating of A-. The portfolio now has 120 bonds from 100 issuers, and the duration of the portfolio is 5.3 years.

Looking forward, the European investment grade market remains supported by the ongoing provision of accommodative monetary policy. The monetary environment is tightening, though only modestly and very slowly. The ECB has wound up its quantitative easing programme, but any interest rate hikes still look some way off. The economic outlook of low but positive GDP growth and low inflation is also a reasonable investment background for corporate markets. We therefore see credit spread widening as an opportunity, especially through new issues that are expected to pick up in the first quarter of 2019. The corporate credit cycle is, however, fairly mature and though earnings have been reasonable, the benefits are largely accruing to equity shareholders. We do continue to expect to see further development of the market for socially beneficial issues and look to encourage this development, not least with our further participation in the ICMA working party for the development of the Social Bond Principles.

Summary: Social Ratings Scores

Social Rating Scores %	Strong [1]	Good [2]	Moderate [3]	Minor [4]	
Impact Investments [A]	20.92	0.87	0.00	0.00	**21.79**
Investment with Impact [B]	5.29	14.28	20.52	0.41	**40.50**
Development Finance [C]	7.77	5.25	11.56	12.20	**36.79**
	33.79	**20.41**	**32.09**	**12.61**	

Source: Columbia Threadneedle Investments as at 31 December 2018.

Summary: Social Outcome Breakdown

	Social Bond	Sustainability Bond	Green Bonds with Social Benefit	General Social Benefit	Cash	Total
Primary Social Needs	**6.59**	**1.88**	**--**	**6.31**	**--**	**14.78**
Affordable Housing	6.59	1.88	--	6.31	--	14.78
Basic Social Needs	**4.35**	**2.90**	**--**	**3.60**	**--**	**10.86**
Health & Welfare	4.35	2.90	--	3.60	--	10.86
Social Enabling	**0.79**	**1.62**	**--**	**1.17**	**--**	**3.57**
Access to Services	--	---	--	1.17	--	1.17
Education & Training	0.79	1.62	--	--	--	2.40
Social Empowerment	**5.99**	**--**	**--**	**1.47**	**--**	**7.46**
Employment	5.99	--	--	1.47	--	7.46
Social Enhancement	**--**	**3.49**	**0.84**	**1.74**	**--**	**6.07**
Economic Regeneration & Development	--	--	0.84	--	--	0.84
Community	--	3.49	--	1.74	--	5.23
Social Facilitation	**0.78**	**0.06**	--	**13.93**	--	**14.79**
Access to Services	0.78	0.06	--	13.93	--	14.79
Societal Development	**--**	**0.39**	**22.93**	**18.24**	**--**	**41.56**
Economic Regeneration & Development	--	0.39	22.93	18.24	--	41.56
Net Cash	**--**	**--**	**--**	**--**	**0.93**	**0.93**
Net Cash	--	--	--	--	0.93	0.93
Grand Total	**18.50**	**10.34**	**23.77**	**46.46**	**0.93**	**100.00**

Source: Columbia Threadneedle Investments as at 31 December 2018.

Key risks

Investment Risk: The value of investments can fall as well as rise and investors might not get back the sum originally invested. **Currency Risk:** Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments. **Issuer Risk:** 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. **Liquidity Risk:** The fund holds assets which could prove difficult to sell. The fund may have to lower the selling price, sell other investments or forego more appealing investment opportunities.. **Inflation Risk:** 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. **Interest Rate Risk:** Changes in interest rates are likely to affect the fund's value. In general, as interest rates rise, the price of a fixed rate bond will fall, and vice versa. **Valuation Risk**: The fund's assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold. **Derivatives for EPM / Hedging:** The investment policy of the fund allows it to invest in derivatives for the purposes of reducing risk or minimising the cost of transactions.

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