Fund commentary
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Information for Investment Professionals

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Threadneedle (Lux) European Social Bond

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

Background

European investment grade credit rebounded during the second quarter, with the fund's composite benchmark* returning 4.1%. The positive quarterly return was chiefly driven by significant tightening in credit spreads. German government bonds were little changed.

Risk assets rallied as the easing of lockdown restrictions, together with ongoing stimulus from governments and central banks, fuelled hopes of a swift 'V-shaped' recovery in the global economy. Optimism was tempered late in the quarter by fears that a second wave of the pandemic could derail the recovery. Rising virus caseloads saw reopening plans reversed in key US states, for example, while curbs were re-imposed in Beijing following a serious outbreak there.

To counter this both the European Central Bank and Bank of England expanded their bond-buying programmes by €600 billion and £100 billion respectively, while the US Federal Reserve and Bank of Japan introduced and increased loan schemes. In June, Germany announced new fiscal measures worth €130 billion to help its own economy; however, EU states remained divided over proposals for a joint €750 billion recovery fund, despite the support of Germany and France.

In company news, there was a further wave of credit-supportive actions as companies cut dividends and abandoned share buy-backs, but some credits fell from investment grade ratings such as Marks and Spencer.

Activity

The coronavirus pandemic continues to dominate the headlines and the bond markets. We have supported new issues intended as a response to the crisis, including from the Council of Europe Development Bank who have adapted its framework so that financing can be extended to the health sector, where countries have increased needs because of the pandemic. As a result, a new Covid-19 Response Social Inclusion Bond was issued, the funding from which will be used to support CEB member countries in mitigating the social and economic impact of the ongoing Covid-19 crisis. The bond will also finance new or existing social projects which support micro, small and medium-sized enterprises (MSMEs) in order to create and preserve jobs. The MSME sector has been hit particularly hard by the coronavirus outbreak across Europe.

* The Fund's composite benchmark comprises 50% ICE BofAML Euro Non-Sovereigns; 50% ICE BofAML Euro Corp Euroland Issuers.

The total volume of ICMA Social Bond issuance year-to-date is now greater than the entire period that preceded it. This, we believe, shows the extent to which bond markets are responding to the current situation and is also evidence of a widening of focus from environmental to social issues. Equally the fund's exposure to Social Bonds rose to 17% through the purchase of social bonds from BBVA, Credit Mutuel Arkea and the region of Wallonia in Belgium.

Our firmly held view is that this social focus should supplement not supplant the environmental concerns and to this end we participated in a number of green bond issues during the period. These included ABN Amro, a Dutch bank with an extensive green bond programme; Alliander who issued its third green bond in June, which will be used to invest in electricity networks; Enexis, another energy provider; and finally KBC a Belgian bank whose sustainability strategy is focused on the SDGs.

We also bought a new transition bond from an Italian energy infrastructure operator. This was Snam's inaugural Transition Bond, which follows the Climate Action Bond issued in February 2019. The bonds aim to contribute to the transition to a low carbon economy and within the Transition Bond Framework, Snam has also identified four specific SDGs (SDG 7, 9,11, 13) as the most material to its own business.

Our focus has continued to be on new issues as they tend to come at more attractive levels than secondary issues. In addition to supporting the Covid-19 response bonds, we have also added a new Social Bond issue from Pearson, the world's leading learning company, headquartered in the UK with 41,000 employees in 70 countries. This was Pearson's inaugural social bond focusing on three main projects: K-12 a free, online learning programme; GED which targets accelerated pathways and functional skills for learners over 16; and BTEC, which provides high quality vocational education.

Overall the effect of this was to improve the average social intensity from 18.1% to 18.2%. The proportion of the fund in (category A) Impact investments remained stable at around 24%, while the proportion of the fund in the lowest social intensity bonds (C3 and C4) is still well below the limit set by the social advisory panel, marking another steady improvement in the benefits to society through the bonds purchased by the fund.

While spreads and yields have fallen over the period, we nevertheless managed to increase the beta of the fund over the period, exploiting the better liquidity that developed as the quarter progressed. Equally we reduced the high cash balance at the start of the period to around 3.65% by the end of the quarter. We maintained duration at slightly longer than the index but sought to build the yield of the fund higher than that of the index by the end of the period.

Outlook

The valuation case has certainly become less compelling since the end of March, given the market's powerful recovery over the last few months. Nevertheless, European investment grade spreads finished June around 0.4 standard deviations (SDs) cheaper than the 20-year average. For context, at the start of this year spreads were around 0.4 SDs more expensive than the long-run average.

The support measures introduced by governments and central banks 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 avoid an economic shock turning into a financial crisis. We have been impressed by the speed, scale and scope of their actions.

In terms of corporate fundamentals, leverage will likely continue to rise as companies issue more debt and accept government liquidity support to weather the storm. However, it is notable that many companies have cut dividend payments and abandoned share buy-backs, which is positive for credit markets.

Summary: social ratings scores

Social Rating Scores %	Strong [1]	Good [2]	Moderate [3]	Minor [4]	
Impact Investments [A]	22.8	1.2	0.2	0.0	24.2
Investment with Impact [B]	4.1	16.1	17.7	1.5	39.4
Development Finance [C]	6.7	1.1	12.2	11.8	31.8
	33.6	18.5	30.0	13.3	95.4

Source: Columbia Threadneedle Investments as at 30 June 2020.

Summary: Social outcomes breakdown

	General Social Benefit	Green Bonds with Social Benefit	Social Bond	Sustainability Bond	Transition Bond	Pandemic Response Bond	Total
Basic Social Needs	**5.6**	**--**	**4.0**	**2.8**	**--**	**1.7**	**14.1**
Health & Welfare	5.6	--	4.0	2.8	--	1.7	14.1
Primary Social Needs	**3.8**	**--**	**2.5**	**1.1**	**--**	**--**	**7.4**
Affordable Housing	3.8	--	2.5	1.1	--	--	7.4
Social Empowerment	**1.1**	**--**	**4.4**	**0.2**	**--**	**2.1**	**7.8**
Employment	1.1	--	4.4	0.2	--	2.1	7.8
Social Enabling	**0.1**	**--**	**0.9**	**0.7**	**--**	**--**	**1.7**
Education & Training	0.1	--	0.9	0.7	--	--	1.7
Social Enhancement	**1.3**	**--**	**0.8**	**1.9**	**--**	**--**	**4.0**
Community	1.3	--	0.8	1.9	--	--	4.0
Societal Facilitation	**13.4**	**2.9**	**1.7**	**0.1**	**--**	**--**	**18.0**
Access to Services	13.4	2.9	1.7	0.1	--	--	18.0
Societal Development	**15.9**	**23.9**	**0.9**	**1.4**	**0.3**	**--**	**42.4**
Economic Regeneration & Development	15.9	23.9	0.9	1.4	0.3	--	42.4
Grand Total	**41.2**	**26.8**	**15.2**	**8.1**	**0.3**	**3.8**	**95.4**

Source: Columbia Threadneedle Investments as at 30 June 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. **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. The risks currently identified as applying to the Fund are set out in the "Risk Factors" section of the prospectus. Please read the Key Investor Information Document and the Fund Prospectus if considering investing.

To find out more visit **columbiathreadneedle.com**