RLPPC Buy and Maintain Fund

Quarterly Report 31 December 2021

Asset split

	Fund (%)
Conventional credit bonds[1]	99.5
Index linked credit bonds	0.2
Sterling conventional gilts	0.0
Sterling index linked gilts	0.0
Foreign conventional sovereign	0.3
Foreign index linked sovereign	0.0
Derivatives	0.0

Fund data

	Fund
Duration[2]	8.3 years
Gross redemption yield[3]	2.19%
No. of stocks	271
Fund size	£50.7m
Spread	1.25%

Source: RLAM. Launch date: 24.06.2015.
[1]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
[2]Excluding cash
[3]The gross redemption yield is calculated on a weighted average basis.
Figures in relation to the asset spilt table exclude the impact of cash where held.
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%) (Accumulation)	Reference index[1] (%)
Q4 2021	**1.04**	**0.34**
Year-to-date	-1.41	-3.09
Rolling 12 months	-1.41	-3.09
3 years p.a.	5.41	4.51
5 years p.a.	3.98	3.24
Since inception p.a. 24.06.2015	5.15	4.28

Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.

Source: RLAM, gross of fees.

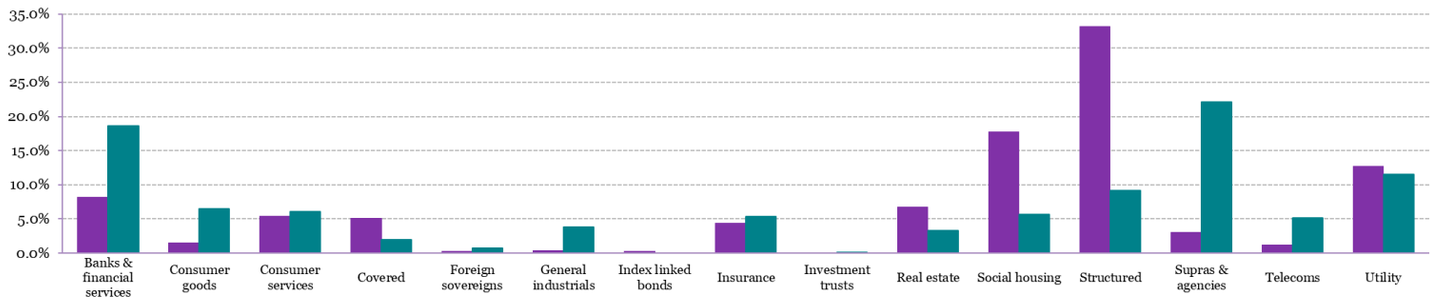
[1]There is no benchmark for the fund. The index data presented in this report is that of the iBoxx Sterling Non-Gilts All Maturities Index and is for reference purposes only. This index is a broad universe of investment grade sterling credit bonds and is therefore a representative comparison.

Downgrades

Representative portfolio	% downgraded to sub-investment grade
RLPPC Buy & Maintain	1.45%
iBoxx Sterling Non-Gilt All Maturities Index	5.87%

Source: RLAM, showing downgrades since fund inception. Portfolio and benchmark percentages are based on weight prior to downgrade. Worst of Moodys, S&P and Fitch ratings are considered. RLAM internal ratings used in absence of any public ratings. Only first downgrades are included in the table.

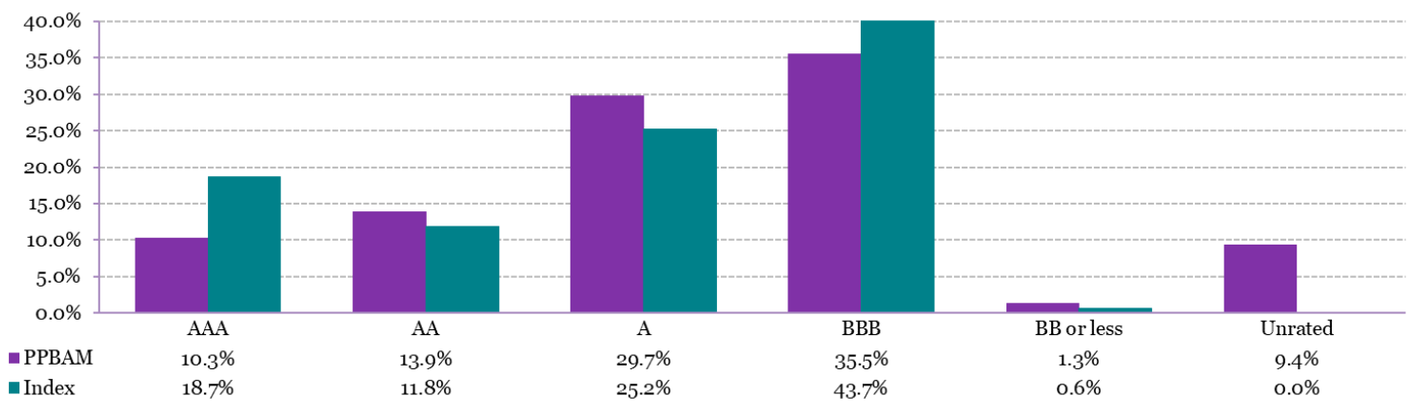
Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Index linked bonds	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
PPBAM	8.1%	1.5%	5.4%	5.1%	0.3%	0.4%	0.2%	4.4%	0.1%	6.7%	17.8%	33.2%	3.0%	1.2%	12.7%
Index	18.6%	6.5%	6.1%	2.0%	0.8%	3.8%	0.0%	5.3%	0.0%	3.3%	5.7%	9.1%	22.1%	5.2%	11.5%

Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

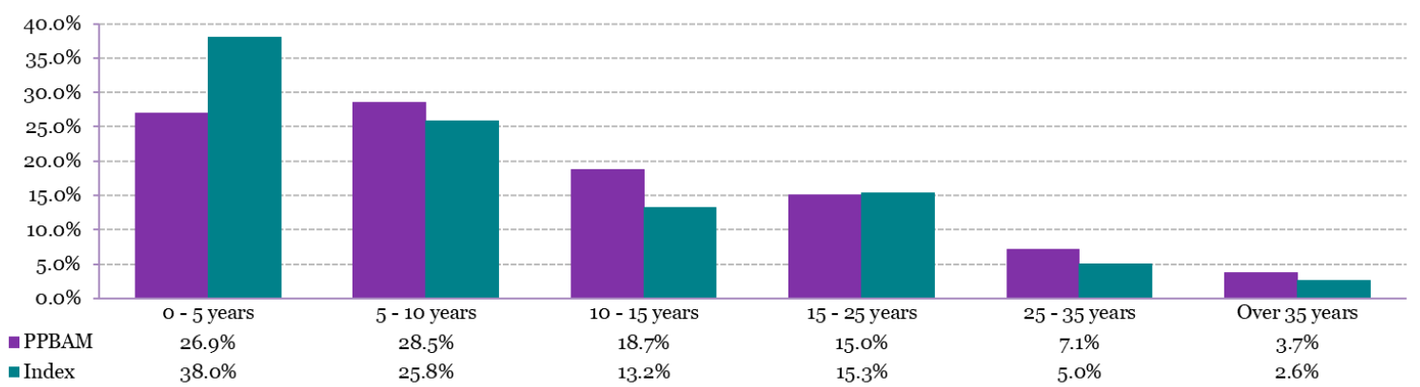
Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPBAM	10.3%	13.9%	29.7%	35.5%	1.3%	9.4%
Index	18.7%	11.8%	25.2%	43.7%	0.6%	0.0%

Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPBAM	26.9%	28.5%	18.7%	15.0%	7.1%	3.7%
Index	38.0%	25.8%	13.2%	15.3%	5.0%	2.6%

Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Ten largest holdings

	Weighting (%)
Électricité De France 6% 2114	1.8
Western Power Distribution 5.75% 2032	1.6
Temasek Financial 5.125% 2040	1.1
Southern Gas Network 4.875% 2029	1.1
Housing And Care 21 3.288% 2049	1.0
Abbey National Treasury 5.75% 2026	1.0
Equity Release 5.7% 2031	1.0
Freshwater Finance 5.182% 2035	1.0
Thames Water Utilities Finance 7.738% 2058	0.9
PRS Finance 2026	0.9
Total	**11.4**

Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding.

Market overview

- The themes that influenced the market earlier in 2021 continued in the fourth quarter: periods of volatility – arising from new strains of Covid-19, renewed travel restrictions and lockdown measures, as well as concern about inflation and the implications for quantitative easing (QE) and interest rates – may have filled the headlines, yet the global economy continued to recover from the impact of Covid-19 and corporate earnings surprised on the upside.
- The travails of the Evergrande property company and the deflation of the Chinese real estate bubble continued, albeit without significant effects on global financial markets. Meanwhile, bottlenecks in supply chains and labour shortages caused by Covid disruption (and, in the UK, possibly exacerbated by Brexit) continued to result in price spikes. For the UK, using implied inflation at a 20-year horizon, 2021 started with a rate just above 3%, before moving higher to 4% during the course of the fourth quarter. Movement at the short end of the implied UK inflation curve was more extreme, mirroring the sharp rise in RPI. Other markets showed similar patterns, as their own inflation measures adjusted to higher energy costs, supply chain bottlenecks and labour shortages.
- Nonetheless, fears of inflation seemed to ease with a change in rhetoric and some action from central bankers. The Bank of England surprised investors in December by raising the UK base rate for the first time in three years – from 0.1% to 0.25% – as the Omicron variant hit the UK, having held steady in November; while the Federal Reserve (Fed) started to taper its QE programme and guide investors to earlier and faster rate rises in 2022. Investors appeared relatively sanguine about these policy changes as they had been trailed from September and, to an extent, taking moderate action on inflation was seen as less of a risk than no action.
- Whereas the third quarter started with the spread of the Delta variant of Covid-19, the fourth quarter began with some confidence about vaccine programmes and the rollout of booster jabs. There was concern about the rapid spread of the Omicron variant as the holiday season loomed; however, while there are ongoing fears about the ability of healthcare systems to cope with the huge numbers of new cases and the impact of staff shortages on key services, investors quickly took comfort from early data from South Africa that suggested that, while highly contagious, this variant is less deadly, and vaccines remain effective in mitigating its effects.
- Over the fourth quarter, the benchmark 10-year gilt yield fell from 1.02% to 0.97%, leading gilts to return 2.42% on an all-maturities basis (FTSE Actuaries). The apparent stability of the gilts market is misleading, however: having risen to 1.20% in late October, the 10-year gilt yield rallied to just 0.70% on 13 December (before the Bank of England raised the UK base rate), then ending the year at 0.97%. For the year as a whole, the rise in gilt yields (from 0.20% to 0.97% for the 10-year gilt) led gilts to return -5.16%. Gyrations in the US treasury market were less extreme than for gilts: starting below 1%, the peak was recorded in March at 1.7% before falling back to 1.2% by August and ending the year above 1.5%. German 10-year bund yields remained negative throughout the year, ending at -0.2%.
- Credit market returns were more pedestrian than gilts for the fourth quarter – sterling investment grade credit returned 0.34%, as the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal

maturity) widened from 0.87% to 0.98%. Sterling investment grade credit returned -3.09% for the year as a whole, outperforming gilts, with the credit spread tightening by one basis point to 0.98%.

- Sterling credit sector returns were mixed for the fourth quarter. Real estate, healthcare, capital goods and utilities were particularly strong, and asset-backed securities again delivered strong returns compared to the broad market. Supranational bonds underperformed as did the financial sectors – senior and subordinated banks were weak, as were the subordinated insurance and covered bonds subsectors. Longer-dated bonds strongly outperformed shorter-dated issues – only bonds with maturities greater than 10 years delivered significant positive returns. Otherwise, A and AA rated bonds outperformed BBB rated bonds, but AAA rated bonds delivered negative returns.

Performance

- The portfolio performed well over the quarter, producing positive absolute returns, and performing well when compared to broad credit markets. Duration positioning was positive over the quarter. The nature of buy & maintain investing means that duration is longer than broad credit indices, and the fall in gilt yields was therefore positive. However, we also saw positive contributions from stock and sector selection.
- Our preference for secured over unsecured bonds was a positive factor as real estate, social housing and asset-backed securities, where we are overweight, outperformed broader markets. Supranational bonds underperformed and our funds are significantly underweight in this sector. In addition, our relatively low exposure to subordinated financials was also helpful, as these also lagged the wider market. Within buy & maintain portfolios, we continue to prefer to be higher in the capital structure when lending to the financial sector reflecting the more conservative risk profile compared to a traditional credit portfolio.
- There were no defaults in our portfolios during the quarter and across the corporate sector failures remain at low levels. While defaults are likely to increase from the current very low levels as we transition back to more normal economic conditions, we believe that our strategies are well positioned to navigate this, as shown in a historical downgrade rate that is lower than the broad sterling credit market.
- Our preference for secured debt over unsecured was a significant factor in our outperformance this quarter as the real estate, social housing and structured sectors all delivered above-market returns. While there was no obvious reason for this, they may have benefitted from other sectors (such as financials) losing momentum. One factor that helps existing asset-backed and secured debt is that they are not subject to regular issuance. This may reduce their liquidity over time but increases their scarcity value, often accompanied by improving capital ratios. Even so, security is not a guarantee of performance and we must still focus on the business model of the issuer.
- At the security level, a notable contribution came from **General Electric** bonds (including GE Capital). We don't tend to favour the general industrials sector and GE wasn't a preferred issuer over many years, due to its low credit spread for credit risk. However, as the company's bonds were downgraded by ratings agencies from AAA, we felt they increasingly offered value; and, when the bonds were downgraded to BBB in 2018, resulting in a material price fall, we added further to our positions. This paid off this quarter as GE tendered for some of its outstanding bonds at a premium to market pricing, following the announcement of its major restructuring.

Activity

- In sterling credit markets, new issuance tailed off in December due to increased volatility and seasonal factors, but all three months of the quarter were stronger than in 2020, and issuance for 2021 as a whole was robust and exceeded expectations. The favourable conditions that were in place in October meant that some deals that looked attractive initially were tightened during the book building phase to levels where we passed; however, as the market became more turbulent, spreads widened to more attractive levels. As ever, activity was driven by reducing holdings where we believe that there has been deterioration in the quality of the credit, or where new issues give us an opportunity to replace holdings with another that offers more attractive spread, lower risk, or both.
- Social housing remains a key area of interest for us. Performance has been strong- both in the fourth quarter and 2021 as a whole, and despite increased interest in the sector, we continue to find new issues at attractive levels. The sector benefits from implicit government support, has no defaults historically, and lending on a secured basis to a sector of societal benefit is an excellent fit for our investment philosophy. Although market interest is growing, we still see inefficiencies in how the market behaves in this sector as many do not have the research capabilities or experience to deal with the unique nature of the bonds and the assets underpinning them.
- During the quarter, we added a new 2036 issue from **Southern Housing Group** – this is one of the oldest and largest housing associations, managing over 28,000 homes in London and the South East. The bonds came at a spread premium to other housing associations, but we are comfortable with the fundamentals and are happy to pick up extra spread and believe there is scope for spread compression. We funded the

purchase with proceeds from a buyback of **RSL finance** (which lends to smaller association that cannot access markets directly) from the same sector, after the underlying borrower bought these back at a material premium to market levels.

- Structured bonds are a significant part of the overall portfolio. During the quarter, we bought a mortgage-backed securitisation from **Sage**. This was a multi-tranche social housing securitisation with a low loan-to-value, and we purchased the senior A tranche floating rate bonds which paid a very attractive spread over SONIA. We also added a new issue from the aptly named **Frost**, secured on freezers, and **Highways**, secured on motorway service stations. Both came at a premium to both the wider market and other logistics issues, partly because both are 'non-standard' issues. Outside new issues, we added 2037 **Arqiva** bonds, secured on TV broadcasting towers.
- In real estate, we participated in a 2028 new issue from **Blackstone Property Partners Europe**. This is a REIT structure, with underlying residential, logistics and office assets across Europe, and came to market at a very attractive spread.
- In the financial sectors we maintain a preference for senior bonds. We participated in a number of new issues during the quarter, including a new issue from **TP ICAP**. TP ICAP bonds have historically been a little more volatile than those issued by conventional banks, but we believe this is more than reflected in the spread. In addition, TP ICAP tends to see higher revenues when markets are more volatile, and hence increases diversification within our financials exposure. We also added a new issue from **IG Group**. We used proceeds from the sale of **APT pipelines** to fund these purchases, as part of an ongoing strategy to reduce holdings where we believe ESG risks are greater, notably in gas network bonds.
- There was further issuance of green and sustainable corporate bonds in the quarter. While we welcome the greater recognition of climate challenge and the higher focus on ESG, we do not believe that all 'labelled' bonds offer value or clarity of objective. We will continue to focus on integrating ESG risk and to add incremental value in overlooked areas of the market.

Outlook

- There is considerable uncertainty about the year ahead. The volatility that erupted at points in 2021 has already been evident this year as the minutes of the December FOMC meeting (published in early January) indicated that the Fed is prepared to increase rates earlier and faster than previously signalled. This has caused weakness in government bond markets and to a reappraisal of more highly rated equity sectors, such as technology. With the withdrawal of QE programmes and the expectations of strong global growth in 2022, markets are pricing in at least three Fed hikes this year and four more from the Bank of England.
- Despite the current spike, we are not convinced about the arguments for inflation returning in the long term. There are plenty of potential factors that may mitigate inflationary pressures, including higher taxes, the slowdown in growth in China (arising from the deflation of the Chinese property bubble and the government's zero-tolerance approach to Covid-19) and the possibility of lower energy costs in the latter part of the year. Overall, whilst central banks are raising interest rates sooner than anticipated a few months ago, we believe that inflation will ease considerably by the second half of this year and that we remain in a relatively low interest rate environment.
- Nonetheless, we remain cautious on government bonds. This reflects both the waning impact of QE and the bounce back in economic growth. There is scope for US treasuries to settle above 2%, with real yields moving higher and yield curves to steepen. However, on a secular basis we remain in a relatively low growth phase – despite technological advances. We cannot buck the long-term impact of ageing societies, nor the bills that will need to be paid for Covid and preparing for the next pandemic. In the UK this means more of our national spending going to the NHS – and more issuance of government debt.
- Credit generally outperforms government bonds – with the caveat that when it underperforms, the magnitude can be meaningful; for long-term investors the balance of outcomes sits firmly in favour of credit. However, credit risk is not something that should be taken unthinkingly, and it is our view that we can harvest a spread premium and mitigate risk through a focus on covenants, security and diversification.
- We will maintain our long-standing focus on risk management by seeking to identify companies with strong balance sheets; favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers, sectors and other factors.

Find out more

- A record number of current and prospective clients and consultants joined us online for the *2021 RLAM Investment Series* (our annual client conference) between 1 and 5 November 2021. Fund managers and other in-house specialists addressed the macroeconomic environment and prospects for different asset classes, and the issues that they consider in managing their funds. There were also sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. All the sessions are available to watch on demand – please visit the RLAM Digital Insight Hub.

- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2022 document, and regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk. Head of Fixed Income Jonathan Platt writes a weekly blog each Monday on key issues in sterling credit and other fixed income markets.

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