



Royal London Sterling Credit Bond Fund

Quarterly Report
31 December 2022



Asset split

	Fund (%)	Benchmark ¹ (%)
Conventional credit bonds ²	99.3	99.3
Index linked credit bonds	0.4	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.2	0.7
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0
Other	0.1	0.0

Fund data

	Fund	Benchmark ¹
Duration ³	6.0 years	6.0 years
Gross redemption yield ⁴	6.96%	5.39%
No. of stocks	356	1,190
Fund size	£2,056.2m	-

Source: RLAM, based on the Z share class. Launch date: 31.08.2008.

¹Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.

²Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

³Excluding cash

⁴ Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the fund is the average for its individual holdings, weighted by their current value, net of relevant fund management costs and gross of tax.

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 (%)	Benchmark ¹ (%)	Relative (%)
Q4 2022	6.48	5.74	0.75
Year-to-date	-16.56	-17.72	1.16
Rolling 12 months	-16.56	-17.72	1.16
3 years p.a.	-3.10	-4.92	1.82
5 years p.a.	-0.03	-1.55	1.52
10 years p.a.	3.60	1.96	1.64
Since inception p.a. 31.08.2008	5.97	3.80	2.17

Past performance is not a guide to 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. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.

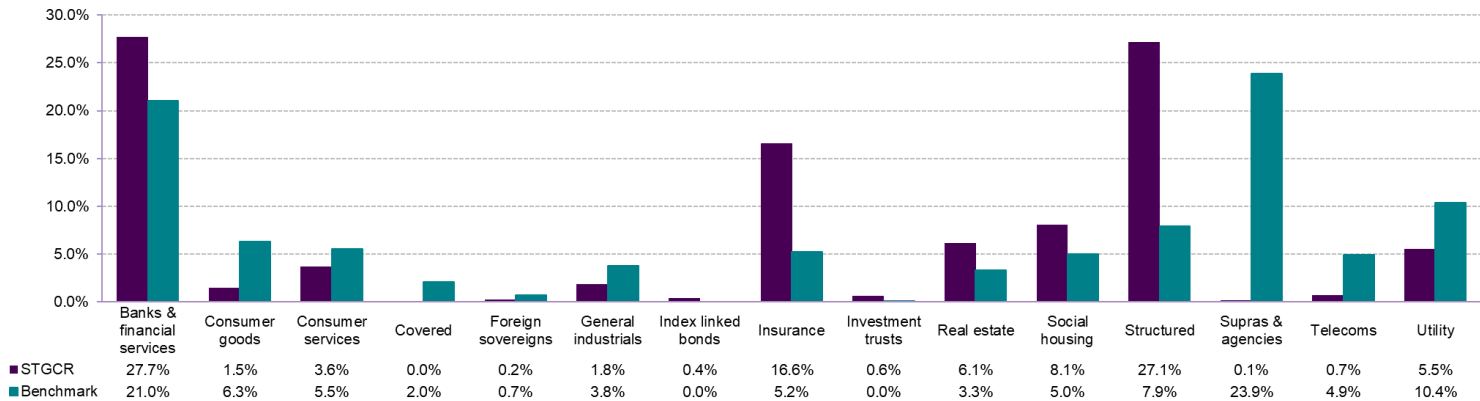
Source: RLAM, based on the Z share class.

¹Benchmark: iBoxx Sterling Non-Gilt All Maturities Index.

Performance for the Royal London Sterling Credit Bond Fund is based on the fund's pricing point at noon, while index performance is based on close of business prices, thus preventing a direct comparison of performance. The significance of this timing discrepancy is likely to be less over longer measurement periods.

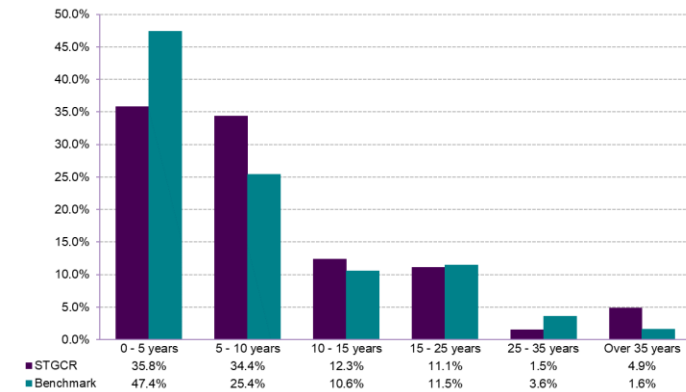
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

Sector breakdown

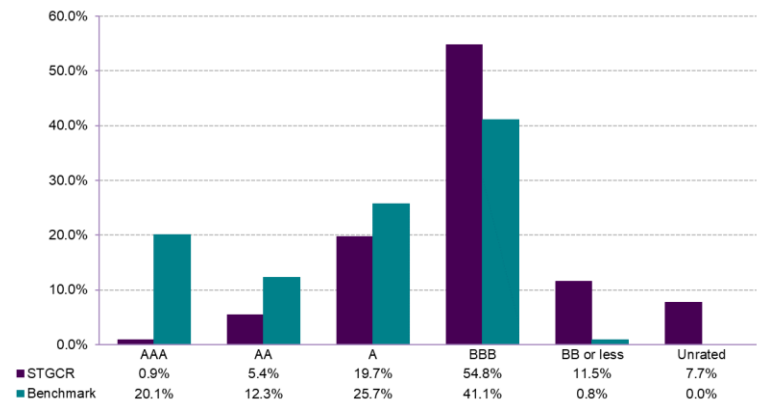


Source: RLAM. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio

Maturity profile



Credit breakdown



Ten Largest Holdings

	Weighting (%)
HSBC Holdings 8.201% 2034	1.5
Aviva 6.875% 2058	1.3
M&G Plc 5.7% 2063 VRN Perpetual	1.1
Santander UK 10.0625% VRN Perpetual	1.0
Électricité de France 6.0% 2114	0.9
AXA 6.6862% VRN Perpetual	0.8
Santander UK 10.375% Perpetual	0.8
Assicurazioni Generali 6.269% VRN Perpetual	0.8
Électricité de France 5.875% VRN Perpetual	0.8
Heathrow Funding Ltd 2.75% 2031	0.7
Total	9.4

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



Market overview

- For 2022 as a whole, UK government bonds returned -25.06% while also exhibiting exceptional short-term volatility. The yield on the 10-year gilt rose from 0.97% to 3.67% over the 12 months, touching 4.5% in the turmoil at the end of September. In big picture terms, any gilt with more than 30 years to maturity lost at least half its value in the course of 2022; even five-year gilts lost over 10% of their value. The increase in yield on the sterling investment grade credit index over 2022 was equally dramatic, up from 1.83% to 5.34% at year end.
- After the incredibly difficult first three quarters of 2022, in which the broad sterling credit index returned -22.18%, the fourth quarter was again challenging. Central banks responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The US Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) each raised rates by 1.25% in aggregate over the period. Since March, the Fed has raised rates seven times by 4.25% in total – its 0.75% increases in June, July, September and November were the biggest single increases for nearly 30 years. Investors expect further hikes in 2023 as the services sector of the US economy has remained notably strong.
- The ECB was slower to react, partly due to a more fragmented backdrop with a gap between Germany and ‘peripheral’ economies. However, it ended its bond buying programme in July and increased rates by 0.75% (its first hike for 11 years and a bigger increase than the 0.50% expected by economists). Further increases followed in September, October and December with a clear commitment to raise rates further in 2023. The BoE increased rates to 3.5% over the quarter, taking its tally to eight increases in 2022 and nine so far in this cycle.
- Despite these interest rate rises and volatility, however, risk assets outperformed in the fourth quarter as inflation appeared to be nearing its peak. Investors started to anticipate lower rates of inflation and the peak of the interest rate cycle early in 2023 as central banks pivot away from hawkish monetary policies to more nuanced strategies. In local currency terms (i.e., without the considerable impact of US dollar weakness over the quarter), nearly all major stock markets delivered positive returns for the quarter. Likewise, the broad investment grade sterling credit index returned 5.74%, lifting the annual return to -17.72%, still disappointing but better than feared at the end of the third quarter.
- After falling back in the third quarter, the price of Brent crude oil fell by another 4.0%, to less than \$86 a barrel – this is below the prevailing price at the time of the Russian invasion of Ukraine in late February. Natural gas prices fell over 50% in the quarter as the weather in Europe remained relatively warm. Meanwhile, copper futures recovered to rise by 3.5% in dollar terms despite the evident slowdown in China.
- Currencies continued to be volatile in the quarter, although in the opposite direction as the dollar weakened. The Fed’s apparently softer approach to raising interest rates pushed it sharply lower and the dollar was the weakest major currency over the quarter: it depreciated by nearly 10% against the yen and euro, and by over 7% against sterling.
- UK bond markets continued to be impacted by Kwasi Kwarteng’s ill-fated ‘mini-Budget’ with the BoE forced to intervene in the gilt market. Although this calmed financial markets temporarily, the volatility continued for several weeks, only moderating when new policies were set out by new Chancellor Jeremy Hunt and then confirmed in the Autumn Statement in mid-November.
- As a result, the UK gilt market was the strongest major government bond market over the quarter, delivering a return of +1.7% as the benchmark 10-year gilt yield fell by 42 basis points (bps) from 4.09% to 3.61%. Shorter-dated gilts performed best; gilts with five years to maturity or less provided positive returns of 2.7%, whereas the 15 years or more to maturity segment returned -1.9%. Otherwise, most other significant markets delivered negative returns over the period as yields rose (prices move inversely to yields): the 10-year US treasury yield rose by 5bps to 3.87%; and the 10-year German bund yield rose by 46bps to 2.57%.
- The sterling investment grade credit market returned 5.74% over the quarter, boosted by the fall in gilt yields and the significant tightening of the average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) from 1.99% to 1.61% (iBoxx). The third-quarter outperformance of defensive sectors reversed sharply with the supranational and covered bond sectors underperforming, while the subordinated bank and insurance sub-sectors delivered particularly strong relative performance. Credit quality had a strong impact on relative returns in the period – bonds in the BBB and A ratings band outperformed their investment grade peers, with even the sterling high yield market lagging behind BBB rated bonds.
- Primary credit market activity recovered in the fourth quarter. Despite minimal activity in December, sterling issuance was £11.5bn over the quarter, primarily from the financial sectors. For the year as a whole, however, the total sterling issuance of £50.9bn was below the £62.5bn and £57.0bn for 2021 and 2020, respectively. Similar patterns were also seen in the euro investment grade market.
- Finally, the BoE was active in selling bonds that it had acquired to stabilise markets in the last three years. Despite delays following the ‘mini-Budget’, the BoE also made good progress in reducing its holding of corporate bonds that were bought in the aftermath of the initial impact of Covid-19. Although some commentators were concerned about this overhang, as we expected the BoE has so far been able to do this without a discernible impact on spreads.



Portfolio commentary

- The fund outperformed the broader market over the quarter. This outperformance was primarily driven by positive credit sector allocation, with a notably strong contribution from the significant underweight to supranational bonds, which we feel offer insufficient returns despite the defensive qualities exhibited in more volatile markets. This was enhanced by the significant overweight allocations to subordinated banks and subordinated insurance debt – these sectors were the outstanding performers as the market recovered over the quarter. This was partially offset by the overweight allocations to secured sectors, such as social housing, real estate and structured bonds which lagged the general spread tightening. Underweight positions in utilities and telecommunications also detracted as these sectors bounced back strongly.
- Stock selection was mixed with gains from insurance, utilities and banks offset by the negative impact of stock selection in the structured, real estate and general industrial sectors. Stock selection was particularly strong in subordinated financials: subordinated issues of **HSBC**, **Investec**, **Lloyds Banking Group** and **Barclays** performed strongly in the banks sector, with **Prudential**, **Aviva** and **Scottish Widows** standing out in insurance. In utilities, holdings in bonds of **EdF** (perpetuals and long-dated bonds) and **Centrica** contributed strongly.
- Structured bonds were the main drag on stock selection as they tend to lag moves in the broad market – structured issues of **Intu**, **Premiertel**, **Telereal** and **Mitchells & Butlers** featured as laggards. Nonetheless, we continue to favour these bonds, which tend not to be included in indices, believing that the additional security is undervalued by the market. Stock selection was negative within general industrials due to **Aggregated Micro Power Infrastructure**, whereas real estate was negatively impacted by **Aroundtown** and **Peel Land**.
- The real estate sector has struggled in recent months as property values declined. We remain of the view that secured real estate bonds, which offer bondholders enhanced protection should the issuer be impacted by operational and/or financial challenges, remain attractive.
- Duration generally made a limited contribution to performance as the average duration of our strategies was broadly in line with the market. It is noteworthy, however, that the average duration of the index was down to 5.77 years at the end of the year, compared to 7.70 years at the start. This primarily reflected the mathematical impact of higher yields working through to shorter duration, rather than any fundamental change in the maturity profile of the index.
- Our proven investment philosophy and process again proved robust in the market turbulence following the ‘mini-Budget’ in September and the subsequent challenges experienced by the LDI part of the pensions industry. The impact on the sterling credit market was significant given the sheer amount of debt sold by LDI orientated pension funds to meet collateral calls. We continued to provide liquidity where required and took advantage to buy undervalued credit during the market sell-off.
- There were no defaults in our funds in the quarter and we remain happy with the shape of our sterling credit portfolios. While deteriorating economic and market conditions demand extra vigilance, we are comfortable that our investment philosophy and process will help us to navigate the challenging environment by favouring secured bonds with strong covenants and focusing on bottom-up research to identify borrowers with attractive risk and return characteristics. Our portfolios are widely diversified across sectors, individual issuers and economic exposures. We believe that the lower credit rated segments of our portfolios have yields that more than compensate us for the increased risks. We continue to run overweight positions in subordinated financial debt despite the worsening economic outlook. This reflects our view that capital ratios are robust, while yields are at multi-year highs. Where we have exposure to sub-investment grade bonds and unrated debt, we consider that the diversification and yield benefits are appropriate.
- There was a notable credit rating downgrade for one issuer in the quarter. In early October, S&P Global Ratings downgraded **Swan Housing Association** (a small social housing provider in East London and Essex) from BBB to BB- (i.e., sub-investment grade) following a deterioration in its financial profile and latterly the breakdown of its merger with Orbit. S&P made their move despite a replacement partner, Sanctuary – a much larger national operator – already having been identified. The fund already owned bonds of Swan, but given the flexibility to purchase sub-investment grade bonds, we were able to buy additional bonds at attractive levels from forced index sellers. This proved fruitful as the advancement of discussions with Sanctuary, with potential completion and subsequent bond upgrade in '23, led to strong outperformance from Swan bonds, despite the downgrade, over the rest of the period.
- In the financial sector there were several buybacks and tenders (e.g., **NatWest**, **Investec**, **HSBC** and **Santander**), as banks looked to tidy up balance sheets. Furthermore, some tenders involved the issuance of new bonds – also at attractive rates. Overall, activity in the banks sector was robust and the terms offered by new issuers tended to be generous – **HSBC** and **Barclays** both issued subordinated debt with very attractive coupons in the lows of the market in October that performed particularly well as sentiment recovered. Other new issues of financials debt in which we participated included senior banks issues by **NatWest**, **Morgan Stanley** and **Crédit Agricole**. We also participated in a subordinated insurance issue from **ASR Nederland**. Away from financials, new issuance was more limited. However, we participated in utility issues of **Northumbrian Water** and **Northern Ireland Electric**, and bought a new issue by **GreenSquareAccord**, the social housing provider.



- Secondary market activity was more limited. We were able to buy some financial bonds that were available from investors seeking to raise liquidity for new issues. Although it might appear risky to increase the allocations to banks and insurance companies, with the likelihood of an imminent recession, we are confident that issuers are more robust than in 2008/9 and that capital ratios are healthy.
- The focus on ESG factors was accelerated by the pandemic and then by the invasion of Ukraine, the latter focusing attention on the transition away from fossil fuels both from a geopolitical and climate change perspective. An optically easy way to do this is to sell exposure to utilities and focus portfolios on labelled bonds (such as green or sustainable bonds). But we believe that such apparently 'simple' solutions will not produce desired outcomes for investors or wider society. Our ESG integration retains engagement and in-house research at its core.

Outlook

- Despite recent inflation data, signs of increasing wage pressures and union unrest, particularly in the public sector, we expect inflation to peak in the coming months. This is driven by our view that energy prices will moderate and that weaker GDP growth will reduce the tightness of the labour market. Nonetheless, it is likely that UK interest rates will rise further during the early part of 2023 as the BoE continues to focus on bringing inflation under control.
- Although the economic data remain very mixed, we believe that higher rates will lead to a recession in the UK, impacting company earnings and leading to some increase in credit rating downgrades and default rates. Nevertheless, it is our view that an asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to attractive levels, on both a relative basis compared to government bonds and in absolute terms. We consider that credit spreads discount a significant portion of bad news and that investors are being paid well to take credit over government bond risk. Against this background, we will maintain our focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.
- The 'all-in yield' on sterling investment grade credit (government yield plus credit spread) remains attractive, particularly if inflation starts to fall as we expect. Our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk. Our strategies generally have a significant targeted exposure to BBB rated bonds, but we believe that compensation for default risk remains most attractive in this rating band.

Find out more

- Our *2023 Outlook* is available [here](#), and includes an overview from RLAM Chief Investment Officer Piers Hillier and articles from some of our leading fund managers on the risks and opportunities in their asset classes for the new year. Articles, videos and webinars explaining our latest investment thinking can be found in the *Our Views* section of www.rlam.com, including regular *JP's Journal* blogs from Head of Fixed Income Jonathan Platt.
- In December, we launched the **RL Sustainable Short Duration Corporate Bond Fund**, which is the latest addition to our sustainable fund range. It builds on our established range of sustainable investment solutions and its launch reflects our continued commitment to providing our clients with relevant solutions to meet their long-term return and sustainability goals. Managed by Matt Franklin and Shalin Shan, the new fund combines our strong heritage in sustainable investing with our market leading sterling credit franchise. While the sustainability of a potential bond is rigorously assessed, returns are further underpinned by prioritising issuers offering additional bondholder protections wherever possible, reducing potential exposure to downside risk. Investors also benefit from the fund's exposure to shorter duration assets, thereby limiting the portfolio's sensitivity to interest rate changes. Alongside an attractive yield, the fund offers investors access to a variety of socially impactful sectors that are often out of reach of public equity investors, such as charities, government agencies or privately-owned businesses. For more details, please speak to your RLAM contact.



Risk warnings

- **Investment Risk:** The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.
- **Credit Risk:** Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.
- **EPM Techniques:** The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.
- **Interest Rate Risk:** Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.
- **Liquidity Risk:** In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.
- **Counterparty Risk:** The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.
- **Charges from Capital Risk:** Charges are taken from the capital of the Fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.

Performance to 31 December 2022

	Cumulative (%)					Annualised (%)	
	3M	6M	1Y	3Y	5Y	3Y	5Y
Fund (gross)	6.48	-4.25	-16.56	-9.01	-0.16	-3.10	-0.03
Fund (net)	6.39	-4.42	-16.85	-9.96	-1.82	-3.44	-0.37

Year on year performance (%)

	Q4 2021 to Q4 2022	Q4 2020 to Q4 2021	Q4 2019 to Q4 2020	Q4 2018 to Q4 2019	Q4 2017 to Q4 2018
Fund (gross)	-16.56	0.94	8.03	11.18	-1.30
Fund (net)	-16.85	0.59	7.65	10.82	-1.60

Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

Source: RLAM as at 31 December 2022. All figures are mid-price to mid-price in GBP for the Z Inc share class.



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