# Royal London Sterling Extra Yield Bond Fund

## Quarterly Report

## 31 December 2022

For professional clients only, not suitable for retail clients

## Executive summary

- The fund recorded a return, gross of tax and management fees, of 4.67% for the quarter, giving a total return of -4.36% for the 12-month period. Performance in the quarter reflects the recovery in the gilt market, the tightening of investment grade spreads, and its robust income generation.
- Distributions in respect of the fourth quarter of 2022, payable at the end of February, are 1.77p, 1.62p, 1.66p and 1.64p, respectively, for the A, B, Y and Z class income shares, marginally higher than the 1.74p, 1.58p, 1.63p and 1.62p distributed in respective of the third quarter, and notably higher than the 1.56p, 1.39p, 1.48p and 1.46p distributed in respect of the fourth quarter 2021. While there can be a fair degree of volatility in fund distributions from quarter to quarter, investments in floating rate notes (FRNs), where income is referenced to a margin over short-term rates and has therefore increased over the course of the year, and the higher yield levels recently prevailing for investment of fund flows, have each contributed to this higher income generation.
- After the incredibly difficult first three quarters of 2022, 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 Bank of England (BoE) raised rates by 1.25% in aggregate over the quarter to 3.5%, taking its tally to eight increases in 2022 and nine so far in this cycle. Despite these rises, risk assets outperformed in the quarter: inflation appeared to be nearing its peak and investors started to anticipate the peak of the interest rate cycle early in 2023 and more nuanced monetary policy.
- UK bond markets continued to be impacted by Kwasi Kwarteng's ill-fated 'mini-Budget' in late September 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 1.69% 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%.
- 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).
- Currencies continued to be volatile in the quarter. The Federal Reserve's apparently more dovish approach to interest rates pushed the dollar sharply lower and it was the weakest major currency over the quarter: it depreciated by nearly 10% against the yen and euro, and by over 7% against sterling. Sterling strength negatively impacted sterling investors in overseas assets. Global high yield markets returned -1.50% to sterling investors (ICE BofAML (BB-B) Global Non-Financial High Yield Index).

## Performance

| | Fund (Class A) (%) | Fund (Class Z) (%) |
|---|---|---|
| **Q4 2022** | **4.68** | **4.67** |
| Year-to-date | -4.36 | -4.37 |
| Rolling 12 months | -4.36 | -4.37 |
| 3 years p.a. | 1.76 | 1.76 |
| 5 years p.a. | 3.34 | 3.34 |
| 10 years p.a. | 6.70 | - |
| Since inception p.a. 13.12.2013 | - | 6.07 |
| Since inception p.a. 14.04.2003 | 7.52 | - |

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.

Source: RLAM. Based on the A and Z Income share classes.

Performance for the fund is calculated on a mid basis with income re-invested. The fund returns in the table above are gross of fees. 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.

## Fund commentary

- In another volatile quarter, an area of strong returns was financials as banking and insurance were particularly sensitive to the improving market conditions. Holdings of banks **Barclays**, **Nordea** and **Standard Chartered**, and of insurers **Aviva**, **M&G**, **Phoenix** and **Zurich**, were each up sharply in price in October as the UK emerged from the Kwasi Kwarteng-inflicted gilt market chaos. Another area of particular strength was 'hybrid' bonds, for which the issuer has the option to extend maturity beyond the first call date, but at an increasingly penal interest cost – such bonds of French utility **EDF** in particular performed strongly in November, with a near 10% capital return.
- Performance was also enhanced by corporate activity, including offshore energy sector **Bluewater**'s early repayment of 2023 bonds refinanced with a new issue, and tenders by **HSBC** and **Investec** for 'old-fashioned' lower tier two bonds, now less efficient as regulatory capital, refinanced by issuing new bonds. Such occasions typically provide both a fillip to the value of existing holdings and an opportunity to invest in the new issue. In December, **NatWest** exercised its repayment option, at a yield level equivalent to gilts, of its 'rump' 11½% perpetual bonds – triggering a 45% increase in the value of the bond, from 158 to 230, adding around 0.25% to overall fund performance. Liquidity was also increased by the repayment of **Barclays** 5.33% bonds and shipping company **Navigator**'s 7% bonds, the latter at 101.79 price. In addition, bonds of transport business **Swedish APT** and offshore support services company **DOF Subsea** were also redeemed.
- Unusually, we purchased long-dated bonds in the social housing sector, namely **Swan Housing** 2048 bonds. This small housing association in East London and Essex had been involved in merger discussions with Orbit in order to mitigate some challenges in its development programme from cost overruns and delays related to Covid, but these discussions were terminated. Despite the much larger national operator Sanctuary stepping into the merger process, S&P Global Ratings downgraded the bonds to BB- (i.e., sub-investment grade) from BBB, triggering selling of the bonds. These secured bonds were purchased at a price about 55 and a yield about 8% – boosted by the recovery in the gilt market, Swan bonds recovered and performed strongly in the following weeks. By end December their price had risen to 72, up over 30% from purchase price.
- Apart from the seasonal slowdown in December, new issues activity recovered in the quarter, albeit it was largely focused on the financials sectors as these companies tend to find it easier than corporates to pass on higher yields to their customers. Purchases included bonds of **Commerzbank**, **Investec**, **Santander UK** and **Société Générale**. Most notable perhaps were new issues from **Barclays** and **HSBC**, each issued early in November, each lower tier 2 capital with first calls at five years and seven years, respectively, with potential five-year extensions; and with investment grade ratings and offering yields of 8.4% and 8.2%, respectively. A new issue of **NatWest** 6 ⅜% five-year A rated senior bonds purchased in the month was subsequently sold, crystallising a 3% capital profit. Otherwise, new issue investments included energy sector businesses **Bluewater** and **Enquest**, in each case as a refinancing of bonds held in the fund, at yields of over 14% and 12% respectively and increasing both income and yield for the fund. Additionally, bonds of resources business **Nordic Rutile**, financing the development of its titanium and garnet mining operations, were bought at issue at a yield of 15% – reflecting the high cost of issuing relatively small, unrated, non-benchmark bonds in volatile market conditions.
- Earlier in the quarter, activity comprised of increasing the size of some holdings at the markedly higher yields prevailing after the sharp market setback in August and September. These included property group **Peel Holdings**, utility **Thames Water** and publishing business **Daily Mail & General Trust**, together with insurance companies **Esure** and **QBE,** and **HSBC**. We continued to add to financials holdings in November, buying bonds of **Brit Insurance**, **Aviva**, **Axa** and **Jupiter Fund Management**. Otherwise, we purchased a new issue of energy sector business **M Vest Energy** – the company benefits from the very supportive Norwegian tax regime for energy companies and, while a small unrated issue, the bonds offered a yield of over 13% for their three-year term. A notable purchase in December was bonds of property group **Canary Wharf** on news that Moody's was downgrading the bonds from Baa3 to Ba1 (i.e., from investment grade to sub-investment grade). Purchased at a yield of 11% to their 2028 maturity, these 'green-labelled' bonds had been issued in March 2021 at a 3.4% yield.
- Sales over the quarter included financials bonds of **Skipton Building Society**, **Virgin Money**, **Nordea** and **Investec**; debt of shipping businesses **Golar LNG** and **Euronav**, and of offshore services business **DOF Subsea**; and bonds of media group **Daily Mail**. In addition, the holding of **Impact Healthcare** shares was further reduced, reflecting the present level of bonds yields compared to the income generation of the shares – this relationship was very different on acquisition in 2019 since when the shares have produced an attractive and increasing income and resilient price performance over the period as a whole, while bond yields have risen very sharply. Finally, activity in the quarter in short-dated gilts reflected short-term cash management.

## Outlook

- Despite recent inflation data, signs of increasing wage pressures and union unrest, particularly in the public sector, we expect UK 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.

## Fund price and yields

| | Fund (Class A) | Fund (Class Z) |
|---|---|---|
| Gross redemption yield | 7.88% | 8.15% |
| Gross income yield | 6.55% | 6.81% |

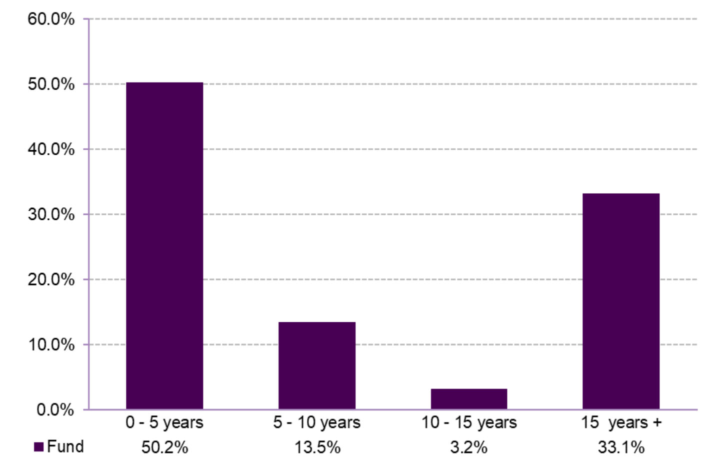
Source: RLAM and State Street. Based on the A and Z share class.
[2]Excluding cash
Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the fund is the average for its individual holdings, weighted by their current value, net of relevant fund management costs and gross of tax

## Fund data

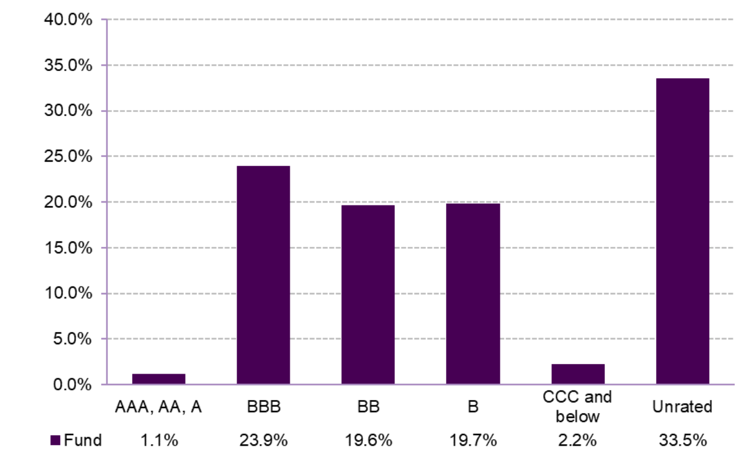
| | Fund |
|---|---|
| Duration[2] | 3.8 years |
| No. of stocks | 213 |
| Fund size | £1,614.4m |
| Launch date | 11.04.2003 |

## Sector breakdown


## Maturity profile




## Credit breakdown




Source: RLAM. Figures include the impact of cash held.

## Ten Largest Holdings

| | Weighting (%) |
|---|---|
| Co-op Group 6.25% 2026 | 2.3 |
| Centrica 5.25% 2025/2075 | 2.2 |
| Électricité De France 5.875% 2029 | 2.1 |
| Santander UK 10.0625% | 2.1 |
| Thames Water 4.625% 2026 | 2.1 |
| Santander UK 10.375% | 1.8 |
| M&G 6.34% 2043/63 | 1.8 |
| Metrocentre Finance 8.75% 2023 | 1.6 |
| Phoenix 5.75% 2028 | 1.6 |
| Heathrow Finance 4.375% 2027 | 1.5 |
| **Total** | **19.2** |

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

## Currency breakdown

| | Fund (%) |
|---|---|
| Sterling | 76.9 |
| US Dollar (hedged 11.8%) | 14.3 |
| Euro (hedged 4.9%) | 5.1 |
| Norwegian Krone (hedged 3.4%) | 3.5 |
| Swedish Krona | 0.2 |
| Canadian Dollar | 0.0 |
| **Total** | **100.0** |

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

## 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.
- **Exchange Rate Risk:** Changes in currency exchange rates may affect the value of your investment.
- **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.

### Performance to 31 December 2022

| | Cumulative (%) | | | | | Annualised (%) | |
|---|---|---|---|---|---|---|---|
| | 3M | 6M | 1Y | 3Y | 5Y | 3Y | 5Y |
| Fund (gross) | 4.69 | 0.66 | -4.36 | 5.38 | 17.86 | 1.76 | 3.34 |
| Fund (net) | 4.46 | 0.23 | -5.16 | 2.78 | 13.24 | 0.92 | 2.52 |

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) | -4.36 | 8.35 | 1.69 | 9.62 | 2.02 |
| Fund (net) | -5.16 | 7.45 | 0.87 | 8.80 | 1.26 |

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

## IMPORTANT INFORMATION

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