RLPPC Enhanced Buy and Maintain Credit Fund

Quarterly Report 30 June 2022

Asset split

	Fund (%)
Conventional credit bonds[1]	99.7
Index linked credit bonds	0.0
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]	7.8 years
Gross redemption yield[3]	4.31%
No. of stocks	460
Fund size	£342.0m
Spread	2.10%

Source: RLAM. Launch date: 16.01.2017.
[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 (%) (Income)	Reference index[1] (%)
Q2 2022	**-7.76**	**-6.79**
Year-to-date	-13.50	-12.56
Rolling 12 months	-13.24	-13.12
3 years p.a.	-1.63	-2.02
5 years p.a	0.63	0.04
Since inception p.a. 16.01.2017	1.20	0.54

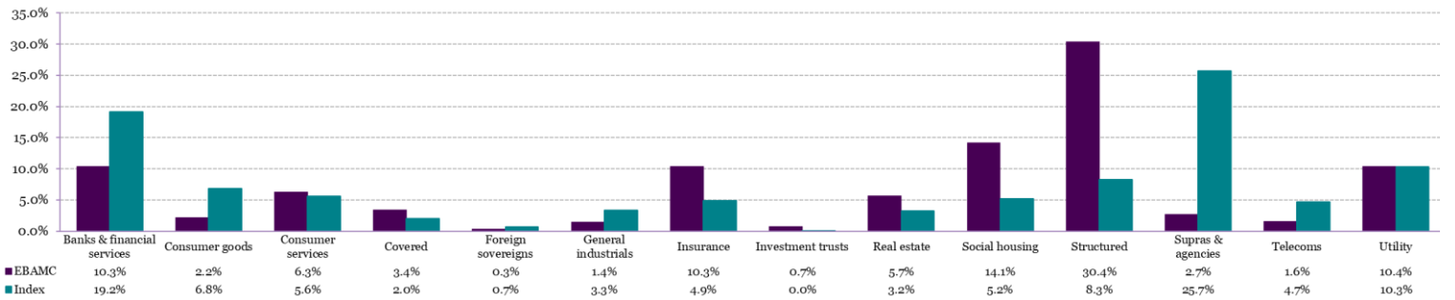
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.
All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.
Source: RLAM, gross of fees. 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.
[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 Enhanced Buy & Maintain	2.99%
iBoxx Sterling Non-Gilt All Maturities Index	2.90%

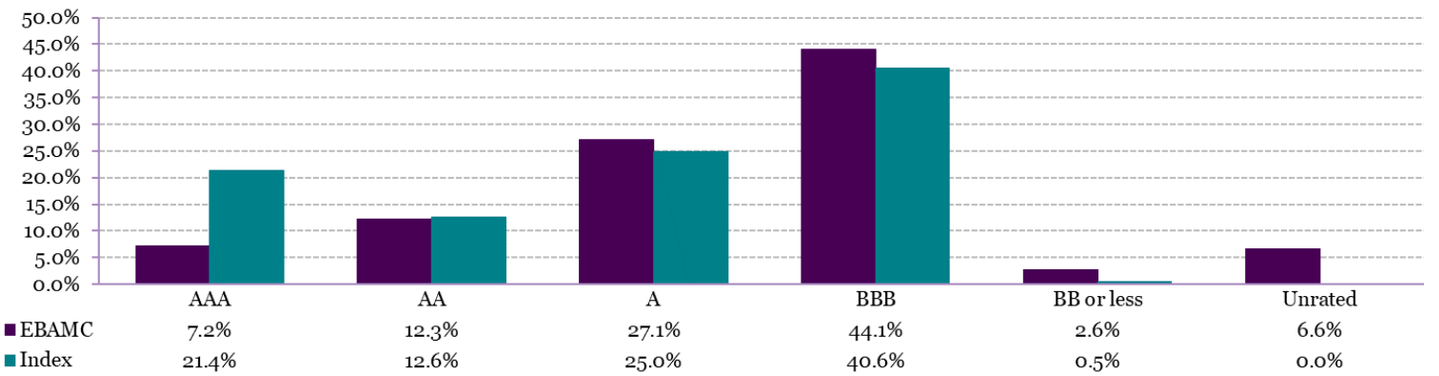
Source: RLAM, showing downgrades since fund inception. Portfolio and benchmark percentages are based on weight prior to downgrade. Worst of Moodys, S&P and Fitch ratings are considered. RLAM internal ratings used in absence of any public ratings. Only first downgrades are included in the table.

Sector breakdown



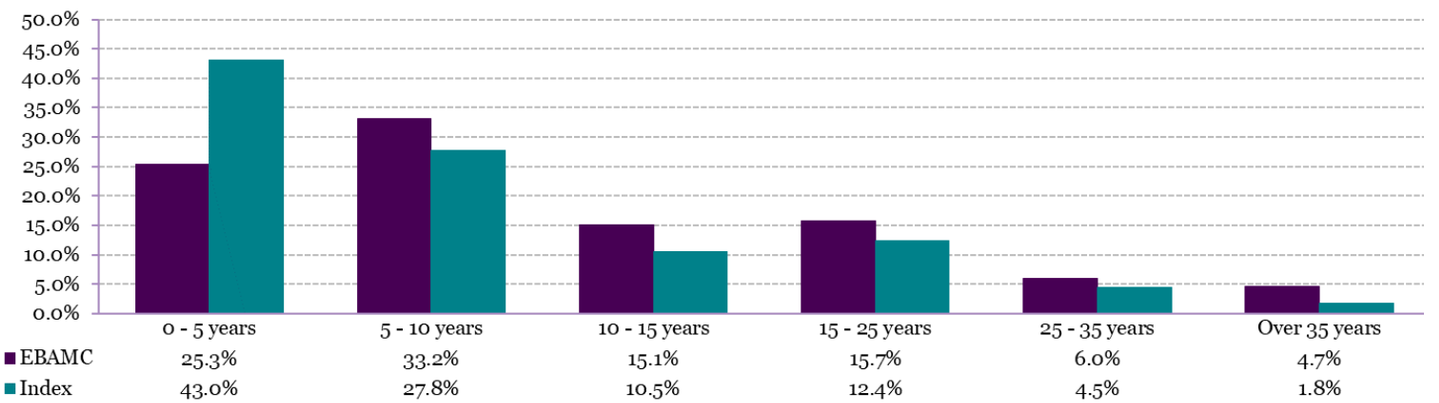
Source: RLAM. Figures in relation to the portfolio exclude the impact of cash held, although they do include the impact of CDs if held within the portfolio.

Rating breakdown



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



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 (%)
Aviva 6.875% 2058	1.0
University of Oxford 2.544% 2117	0.9
HSBC Bank 5.844% VRN Perpetual	0.9
British Land Co 5.264% 2035	0.8
Investec Plc 1.875% 2028	0.8
Temasek Financial Ltd 2.75% 2061	0.8
Clydesdale Bank Plc 4.625% 2026	0.7
Flagship Finance Plc 1.875% 2061	0.7
The Housing Finance Corporation 5.20% 2043	0.7
Zurich Finance 6.625% VRN Perpetual	0.7
Total	**7.9**

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

Market overview

- Inflation has been the headline macroeconomic market influence over the quarter. Increasing energy and commodity prices have added to the natural increase seen as the global economy continued to emerge from its Covid-induced slowdown of 2020 and 2021. Geopolitical events continued to weigh on sentiment as well, as Ukrainian resistance to the Russian invasion continued.
- Central banks have responded to rising inflation by tightening monetary policy and indicating that there is more to come. The US Federal Reserve (Fed) has led the way, increasing rates by 1.25% over the quarter – its clear threat to do more has led markets to price in a further 2% of hikes in 2022. The European Central Bank (ECB) was less aggressive – partly due to a more fragmented backdrop with the gap between German and 'peripheral' bonds widening in recent months – but confirmed that it will end its bond buying programme in July and signalled that a 25bps hike in July and even another 50bps in September will both be possible. The Bank of England (BoE) has increased rates by 25bps at every meeting since December 2021 and this continued through the quarter, with the fifth consecutive increase in June taking the UK base rate to 1.25%.
- In the UK, economic data generally indicated that growth was slowing, while inflation rose each month – CPI inflation for May hit 9.1% and the BoE has suggested it could reach 11% by the autumn. Growth indicators were weak, with composite PMI indicators deteriorating, consumer confidence still below pre-pandemic levels, and GDP underwhelming. A government £15bn fiscal package was designed to alleviate some concerns for consumers.
- Bond markets returns were hit hard in the period, as rising interest rates drove government bond yields higher globally (prices move inversely to yields): the UK's benchmark 10-year gilt yield rose by 62bps to 2.23%; the 10-year US treasury yield rose by 67bps to 3.01%; and the 10-year German bund yield rose by 78bps to 1.34%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk). In the UK, for example, gilt markets returned -7.42% on an all-maturities basis (FTSE Actuaries), whereas gilts with 5 years to maturity or less provided negative returns of just -0.76%.
- Total returns for the sterling investment grade credit market of -6.79% were less negative than gilts in the second quarter, but this was still the worst calendar quarter for sterling credit market this century. However, the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 45bps to 1.74%. This means that, on average, corporate bonds underperformed gilts of an equal maturity.
- In credit markets, defensive sectors continued to outperform on a relative basis, albeit still providing negative returns – supranational, covered and asset backed sectors outperformed, while financials (banks and insurance) were laggards, particularly subordinated bonds. Real estate was particularly weak in the period given the significant rise in base interest rates and future interest rate expectations. Credit quality benefitted relative returns in the period, with bonds in the AAA ratings band outperforming on a relative basis, followed by AA, A and BBB rated bonds – the high yield market underperformed investment grade credit.

Performance

- Sterling credit markets followed the worse quarter since the Global Financial Crisis with an even weaker second quarter. Markets were again driven by the significant rise in yields of the underlying gilt market, with nominal gilt yields rising by around 70bps in the quarter, after a similar move in the first quarter.
- Portfolio returns were negative during the quarter, due to the combination of wider credit spreads and the rise in underlying gilt yields. Reflecting the objectives and nature of buy & maintain investing, the portfolio is not formally benchmarked to a traditional market index, but it is still useful to look at performance in the context of the broader market. The portfolio had a longer duration than broad credit indices and on a comparative basis, this hurt returns.
- Stock and sector effects were mixed. We have only limited exposure to supranationals, reflecting our view that the spread on the sector is unattractive compared to other parts of the credit market, and this damaged returns compared to the broader market. We had greater exposure to the insurance sector, but this sector struggled as these companies have substantial assets on their balance sheets and hence tend to be marked down in difficult markets**,** but these are businesses we believe will remain resilient in the long term. Against this, the portfolio relatively low exposure to subordinated financials was helpful, as these fell by more than the wider market over the period. While the portfolio has pockets of selective subordinate debt, our exposure is diversified and controlled via limits. Our exposure to covered bonds – these generally being shorter-dated, secured bonds, was also helpful. Finally, when looking at our portfolio compared to the market, our stocks selection in real estate, social housing and structured was positive. In the latter, structured bonds from **Telereal** performed well, demonstrating the value of secured lending in uncertain markets.

Activity

- Issuance was relatively low during the quarter. But after a sustained period of higher issuance, it is little surprise to see a pause. While higher yields and spreads hurt absolute returns, market weakness has given us opportunities to add high quality cashflows at attractive spread levels. At the same time, the rise in yield has pushed portfolio duration lower, as longer dated bonds typically fall more in weaker bond environments. While we have occasionally bought bonds that help increase duration, we have not made wholesale moves, as this could involve selling bonds that are more liquid and shorter duration, in favour of longer bonds. While we are happy to do this where it enhances spread or overall quality, we tend to avoid such trades for purely duration purposes as these can be poor value for little benefit.
- The social housing sector remained a key area of interest, with an attractive combination of strong ESG credentials, high quality cashflows, security and no defaults. During the quarter we bought a new issue from **bLEND** – an aggregator which helps smaller housing associations access capital markets – which came to market and **Jigsaw**. We also added a new issue from **Hexagon**, a smaller association operating 4,500 homes in south-East London and looking to add 400 homes per annum through grants and limited shared ownership, but one that is highly rated and offered an attractive spread compared to the sector.
- Financials, notably banks, remain a material part of the sterling credit market. Financials had lagged in March and April, and new issue pricing was therefore attractive, adding senior bonds from US name **Goldman Sachs** at a spread of around 180bps. Within the insurance sector, we carried out a relative value switch, selling 2030 bonds from **Pension Insurance Corporation** and buying 2032 bonds from the same issuer, adding over 10bps of spread for marginal interest rate risk.
- Structured bonds remain a key element in the portfolio. **Telereal** is a key infrastructure asset for the UK, leasing telephone exchanges to BT (British Telecoms) and enabling BT to provide its fixed line telecommunication network. Telereal undertook a liability management exercise in the quarter, which we participated in – as part of this exercise, the company redeemed two bonds at a significant premium. The company then issued two new bonds at above-market spreads, and given the secured nature of the bonds, the key importance of the underlying assets for the UK and their strong credit ratings, we were happy to buy the new bonds.
- Away from traditional areas of focus, we added a new issue from **Rentokil**. The bonds are BBB rated and came to market at a spread of just over 250bps, providing attractive carry and adding global diversification.

Outlook

- Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, central bank interest rate increases are already showing signs of slowing down activity and we believe that inflation will peak in major economies during the second half of 2022. Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see a move

higher in default rates. We will maintain focused on 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.

- Despite the worsening economic outlook, we believe that the widening in credit spreads has taken valuations to attractive levels, relative to government bonds. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the long end of markets where all-in yields still look challenging.
- The BoE announced in May that it will begin the sale of its holdings of corporate bonds from the week commencing 19 September, via a regular multi-stock auction. While its buy programme had a significant (if only temporary) impact on sterling credit markets, we do not expect the same for the sale. Although the holding is material in size, it is not a structurally significant portion of the market, and with the proposed sale's timescale of more than three years, it is unlikely that markets will see enough concentrated activity to generate large swings in pricing.

Find out more

- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars and other mediums. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.com, including regular *JP Journal* updates from Head of Fixed Income Jonathan Platt.

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